



The Role of the Asset Management Entity

An East Asian Perspective

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Summary

East Asia's¹ financial systems are burdened with a large volume of nonperforming assets (NPAs),² including nonperforming or past due loans and real estate and other assets pledged as collateral for loans. These assets impede the ability of financial institutions to serve the prudent intermediation needs of their communities. The faster such problems and their causes are dealt with, the better. Experience has repeatedly shown that delay usually makes resolution programs more complex and costly and slows economic recovery.

To resolve NPA problems and help restore the health and confidence of the financial sector, the countries in East Asia have used one or more asset management company (AMC) models. The most common AMC model used centralizes this activity in a government agency. However, some countries have opted for a more decentralized approach involving the creation of several "bank-based" AMCs. Each model has its advantages and disadvantages, and there are no ironclad rules regarding which approach to use in a given instance. In general, though, the more pervasive or systemic the problem or the less developed the business culture or legal infrastructure, the greater the need for coordination and for emergency legal reforms or special powers to resolve NPAs or both. In such an environment, a centralized, government-based strategy may be the most effective. On the other hand, if a country's NPA problems are limited or concentrated and the government can afford to take a gradual approach, a bank-based AMC may be more appropriate. But regardless of the approach taken, the following guiding principles are suggested for the creation and operation of AMCs:

- Assess the scope, magnitude, and implications of the NPA problem objectively and thoroughly;
- Develop and implement business plans for prompt action;

- Recognize the need for and obtain objective expert advice;
- Select and coordinate the appropriate NPA resolution strategy and AMC model;
- Establish clear goals and objectives for the AMC;
- Promote the transparency and consistency of the AMC's operations;
- Minimize potential conflicts of interest in the AMC's operations;
- Provide the AMC with adequate operational authority;
- Provide for objective oversight and governance of the AMC;
- Provide the AMC with adequate purchase and operational funding;
- Assess the need for and provide the AMC with special legal powers;
- Organize the AMC to maximize its efficiency and expertise;
- Develop performance-based asset management and recovery plans and principles;
- Plan for the best use of private-sector asset management;
- Promptly evaluate and implement management information systems;
- Value assets carefully, consistently, and objectively;
- Provide essential asset management in the interim; and
- Support asset value enhancement decisions with cost-benefit analysis.

The severity of the NPA problem in East Asia ranges from significant to severe, perhaps even overwhelming. Some countries appear to be farther along than others in addressing their NPA problems, but, as noted below, all are still trying to cope with a difficult and challenging task.

In Thailand, the government dealt promptly and decisively with NPA problems in the finance companies, but has not done the same for the banking sector, where NPA problems are still pervasive. The

current government policy of encouraging state-owned and private banks to establish their own AMC appears overly optimistic and is likely to require substantial government coordination and financial support.

In Indonesia, the NPA problems appear to be the most severe by far, of all the countries surveyed. The sheer magnitude of the fiscal and political cost of resolving the NPA problems requires drastic action and broad public support. Policies and procedures must be perceived as transparent, fair, and effective. But in the current political environment, resolving NPAs will be extremely difficult.

In Malaysia, the government promptly reduced NPA problems by transferring them to a centralized, government-run AMC. While it is still too early to tell, the approach appears well coordinated and comprehensive. The government plan allows banks to retain NPA levels of up to 10 percent. How this will affect bank operations is not clear. Also, the soundness and enforceability of the government's policy of requiring banks to increase their loan growth to 8 percent appear questionable. The potential impact on domestic lending and foreign investment of the AMC's extensive powers to unilaterally control debtor obligations is not known. Another unknown is the extent to which the AMC's plans to enhance asset values will affect the development of a market-based private sector.

The Korean government has achieved major strides in addressing the loan problems in the financial sector. The government AMC faces an important challenge but is actively working to improve its management of distressed assets. At issue is the legislative authority of the government AMC to make working-capital advances to debtor companies.

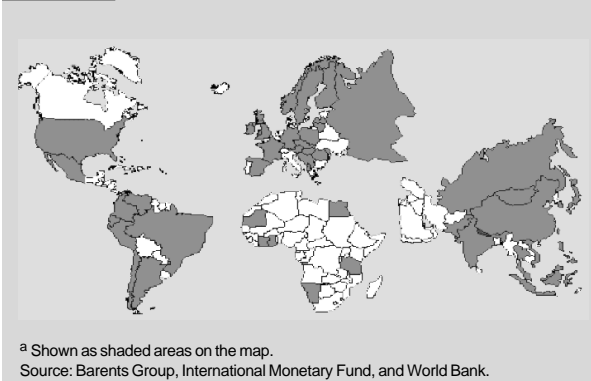
In the Philippines, problem assets are significant in extent but substantially less than in other East Asian countries. The experience of the AMC in the Philippines provides valuable insights into the importance of operational independence.

Introduction

Purpose of the Study

The past two decades have seen more than a hundred banking crises worldwide. Most problems in the financial sector culminate in high levels of nonperforming assets (NPAs). To resolve their NPA problems, countries have tried various bank restructuring and asset management strategies. Many countries have set up, or are setting up, some type of asset management company (AMC) to acquire, manage, and recover the NPAs of troubled or failed financial institutions (see Figure 1).

Figure 1: Countries Where Asset Management Companies Have Been Established or Are Being Contemplated^a



This study has four objectives:

- To review the impact of NPAs on East Asia's financial institutions and economies,
- To review potential strategies for resolving NPA problems,
- To analyze AMCs in general and from an East Asian perspective, and
- To propose guiding principles for the design and operation of AMCs.

The study gives a general overview of the resolution strategies and operations of AMCs in several countries. (Further details are provided in Appendixes 1 and 2.) It excludes specific policy recommendations for East Asian governments. Information was gathered from professional experience, available published sources, and a limited number

of meetings with government and private-sector officials in Indonesia, Korea, Malaysia, Philippines, and Thailand.³

Causes and Effects of Nonperforming Asset Buildup

As the “Asian miracle” brought high levels of capital inflows to East Asia, the lack of developed capital markets, coupled with an inexperienced financial sector, resulted in many imprudent credit decisions. Often, loans were made at the direction or encouragement of governments, to promote industrial growth and macroeconomic goals. Prudential lending standards and supervisory safeguards were largely absent. Businesses became highly leveraged and vulnerable to market and economic setbacks. When local currencies were devalued, major companies could no longer service their foreign currency-denominated debt. The funding problems of major companies led to a chain reaction throughout the economic food chain. Smaller companies lost their access to working capital. The credit faucet that had been so free-flowing was abruptly turned off. Table 1 indicates the magnitude of the financial crisis in East Asia.

High levels of NPAs can severely affect an economy in several ways. Earning assets in the financial sector decline even as operating expenses increase. Management and financial resources are diverted to NPA problems and away from more productive uses. The illiquid nature of NPAs and loss of depositor and interbank confidence often give rise to funding problems.

NPA problems can make banks very averse to risk capital in making new loans. Conversely, banks, hoping to increase their capital, may choose to take on even riskier loans. Neither course of action is good for business. The first results in a credit crunch that slows the pace of economic recovery. The second only worsens NPA problems. NPA problems can also dramatically impede the efficiency of property markets. Real estate properties tied up

Table 1: Magnitude of Financial Sector Crisis in East Asia

Country	Type and Approach
Indonesia (1997 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> • 70% of loans (about 50% of gross domestic product [GDP] in 1997) were nonperforming. <p>Insolvent Banks</p> <ul style="list-style-type: none"> • 16 small banks were closed by the government in 1997. • 54 banks (constituting about one-fourth of total banking assets) were government-controlled/-supervised as of year-end 1998. • 38 banks were closed, 9 were recapitalized, and 7 were nationalized in March 1999. These institutions represented about one-fifth of bank deposits.
Korea (1997 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> • 35% of loans (about 35% of GDP in 1997) were nonperforming. <p>Insolvent Banks</p> <ul style="list-style-type: none"> • 5 small banks were closed, 2 large banks were nationalized, and 7 banks were recapitalized. These institutions represented more than one-fourth of total banking assets. • 18 out of 30 merchant banks were insolvent (merchant banking assets represented about 5% of total banking assets).
Malaysia (1998 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> • 30% of loans (about 40% of GDP in 1997) were nonperforming. <p>Insolvent Banks</p> <ul style="list-style-type: none"> • 10 financial institutions (representing about one-eighth of total banking assets) received a RM6.2 billion injection. • Mergers among commercial banks, finance companies, and merchant banks are encouraged by the government.
Thailand (1998 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> • 50% of loans (about 70% of GDP in 1997) were nonperforming. Nonperforming loans (NPLs) for the largest domestic bank were reported to be as high as 84%. <p>Insolvent Banks</p> <ul style="list-style-type: none"> • 58 finance companies (representing about one-eighth of total banking assets) were suspended by the government. • Government intervened in 6 local commercial banks and signed memorandums of understanding with 4 others. These institutions represented about one-third of total banking assets.

Source: Appendix Table A2.1.

as collateral to defaulted loans can create stagnant property markets with excess capacity. Finally, the unavoidable government costs of resolving systemic NPA problems can overwhelm fiscal budgets and divert resources away from important government programs.

THE ROLE OF BANK CREDIT

Before the Asian financial crisis, the export boom in the region created tremendous capital inflows that went largely to financial institutions, predominantly banks. Capital markets were too new or too undeveloped to absorb the funds directly. Thus, financial leverage provided by banks was used to promote fast-paced private-sector growth. Table 2 shows the ratio of domestic credit growth to gross domestic product (GDP) growth. Much of this growth went to the real estate sector, especially in Indonesia, Malaysia, and Thailand where 30 percent or more of the loan portfolios were in real estate credits.

Table 2: Ratio of Growth in Domestic Credit to the Private Sector to GDP Growth, 1990–1997 (percent)

Country	1990–1995	1996	1997
Indonesia	1.3	1.2	na
Korea	1.1	1.3	1.4
Malaysia	1.4	1.8	2.5
Philippines	3.2	3.2	2.5
Thailand	2.1	1.5	4.0

GDP = gross domestic product.
na = not available.
Source: Calculations based on IMF figures.

THE ROLE OF BANKING REGULATION AND SUPERVISION

In a number of Asian countries, financial liberalization and inadequate licensing controls resulted in intense competition within the financial sector. Domestic banks had to compete against foreign banks, non-bank financial institutions, and newly chartered banks. Competition for business often leads to a relaxation of lending standards. The risk of asset deterioration is even greater when, as was the case in most of East Asia, the financial sector does not have much experience in managing problem assets. In such an environment, it is vitally important to have in place an effective regulatory and supervisory framework that promotes safe and sound banking practices. In East Asia, such a framework did not exist before and during the economic boom. Regulators were unprepared, and licensing controls, enforcement tools,

and accounting and lending procedures proved to be inadequate. Capital adequacy and loan classification criteria were not well established or enforced. Regulatory standards for currency risk management, credit evaluation, and public financial disclosure were lacking. Easy access to credit, plus intense competition for loans and inadequate supervision, leads to asset quality deterioration.

MAGNITUDE OF NONPERFORMING LOANS

As Table 3 shows, financial institutions in East Asia were, or continue to be, burdened with very high levels of nonperforming loans (NPLs).⁴ As previously noted, neither NPAs nor NPLs are uniformly defined. The US classifies as nonaccrual or nonperforming all loans for which interest payments are past due for at least 90 days. Possibly by using a more lenient definition of NPLs, several East Asian countries appear to have underestimated the true levels of their NPLs. According to the central bank of Indonesia, for example, NPLs for all commercial banks stood at 20 percent as of March 1998. The table shows the estimated NPL levels and their percentage as well as that of domestic credit to GDP, during the peak years of the crisis. As illustrated in the table, the amount of leverage or bank credit in an economy will determine the real size of the NPL problem and the ultimate cost of resolution.

NONPERFORMING ASSETS AND FISCAL COST

Many countries tend to put off acting on their NPA problems partly because the cost of not addressing them is less direct. However, when they do eventually deal with such problems, the impact on state budgets is extensive, as Table 4 shows. Moreover, given the estimated levels of nonperforming loans, some of these cost estimates are likely to rise.⁵

FINANCIAL IMPACT OF NONPERFORMING ASSETS

NPAs affect the financial condition of a bank in several ways. Banks must set aside loss provisions for

Table 3: Magnitude of NPLs

Country	Peak Year of Crisis	% of Domestic Credit to GDP	% of NPLs to Total Loans	% of NPLs to GDP
Indonesia	1998	75	70	53
Korea	1998	100	35	35
Malaysia	1998	140	30	42
Philippines	1998	30	15	5
Thailand	1998	140	50	70
Mexico ^a	1995	30	>50	>15
Sweden	1992	60	11	7
United States	1992	60	3	2

GDP = gross domestic product, NPL = nonperforming loan.

^a The government of Mexico has estimated the country's peak NPL levels to be 13 percent, considering only past-due interest and not the balance of the loans. Aggregate peak NPL levels are estimated to have been at least 50 percent.

Source: *Asiaweek*, 8 January 1999; *Emerging Markets Investor*, November 1998; International Monetary Fund, *International Financial Statistics*, 1998; and Barents Group experience and interviews.

Table 4: Estimated Amount and Annual Interest Cost of Government Debt Issued to Pay for Bank Restructuring, as of December 1998

Country	In Local Currency	Approximate US\$ Equivalent	% of GDP
Amount			
Indonesia	Rp300 trillion	70 billion	29
Korea	W74.7 trillion	60 billion	18
Malaysia	RM48.4 billion	13 billion	18
Philippines	P100 billion	3 billion	4
Thailand	B1.6 trillion	43 billion	32
Annual Interest Cost			
Indonesia	Rp40 trillion	5.4 billion	3.5
Korea	W8 trillion	6.4 billion	2.0
Malaysia	RM3.5 billion	0.9 billion	1.3
Philippines	P11.9 billion	0.3 billion	0.5
Thailand	B143 billion	4.0 billion	3.0

Source: International Monetary Fund, *World Economic Outlook and International Capital Markets*, December 1998.

adversely classified loans.⁶ Even with more liberal classification standards, most East Asian banks do not earn enough to charge for these provisions and would need to substantially reduce their capital account. Reductions in capital can raise severe problems in complying with regulatory capital and lending limit regulations as well as in maintaining market confidence.

The more funds a bank needs to reserve for losses, the less its capital leverage to make new loans. Also, the quality and quantity of bank earnings suffer as assets become nonperforming. Net interest margins⁷ shrink as a result of the loan interest income lost. Likewise, options to increase loan yields are limited

when NPA levels are high and the economy is under stress. Good loans are hard to find and banks are unable or unwilling to make them. Some banks, desperate to increase asset yield, resort to making higher-yielding but riskier loans. In general, however, banks make fewer loans, resulting in a credit crunch. Net interest margins typically are further squeezed by rising funding costs caused by a decline in public and investor confidence. Governments can help offset rising funding costs by taking such actions as lowering reserve requirements or providing low-cost liquidity loans or deposit guarantees. The fiscal and monetary impact of such actions should, however, be carefully evaluated.

NONPERFORMING ASSETS AND THE CREDIT MARKET

Table 5 shows the impact of the financial crisis over the past three years on the growth of loans in selected East Asian countries.⁸ As might be expected, the pace of loan growth slowed dramatically, reflecting the economic turndown.

NONPERFORMING ASSETS AND THE PROPERTY SECTOR

Financial institutions directed much of their lending to real estate, helping inflate market prices. Now that the bubble has burst and asset values have declined, the existence of NPAs is causing continued difficul-

Table 5: Growth of Loans, 1996–1998 (percentage change over previous year)

Item	1996	1997	1998
Indonesia			
Commercial banks ^a	24	26	12
Korea			
Deposit money banks	16	13	(1.5)
Other financial institutions	22	15	(20)
Malaysia			
Commercial banks	25	27	5
Finance companies	na	24	(15)
Thailand			
Commercial banks	14	25	(10)
Finance companies	14	(64)	na

() = negative values are enclosed in parentheses, na = not available.

^a Annualized estimates.

Source: Central banks.

ties in the property sector. As Table 6 shows, vacancy rates are increasing while capital values and rents are falling in East Asian economies.

NPA problems affect the property sector by leaving banks and other financial institutions with a large inventory of existing or potential foreclosed real estate. Banks are likely to be reluctant to sell these properties aggressively to avoid additional losses. Investors, on the other hand, become unwilling to buy as long as a large property inventory remains because of the potential impact on pricing. The result is an inefficient market, a sluggish real estate sector, and a delayed recovery.

When faced with growing levels of NPAs, governments tend to look to the financial sector for remedies rather than commit government resources. However, this strategy often backfires. Governments must fully understand both the scope of the problem

and the capacity of the banking sector before relying on it to work its way out of the situation. Otherwise, if the banking sector lacks the required capacity and particularly if the NPA problem is severe, the problem could only get worse, and could even put the country's political, social, and economic infrastructure at risk. Programs that effectively resolve systemic NPA problems must be implemented promptly and comprehensively.

Programs to Resolve Nonperforming Asset Problems

Resolving problems in the financial sector involves setting priorities and making difficult decisions. The process is usually painful and there are no easy choices. Also, goals and objectives tend to change in priority at various stages in a financial crisis. This section will discuss how these goals and priorities change and describe the NPA resolution programs most often used worldwide. Finally, the resolution strategies used by selected countries will be reviewed.

Resolution Goals and Priorities

Resolution goals and priorities tend to depend on the nature and magnitude of the crisis as well as a wide range of political, social, and economic factors. Priorities usually change over time and objectives may conflict, resulting in trade-offs and compromises. In the early stages of a systemic crisis, primary emphasis is

Table 6: Vacancy Rates, Capital Values, and Rents in East Asia

Item	Office Vacancy Rates (%)		Percentage Change, 1995–1998	
	1995	1998	Capital Value	Rent
Bangkok, Thailand	21	30	(45)	(32)
Jakarta, Indonesia	9	23	(67)	(42)
Kuala Lumpur, Malaysia	4	15	(22)	(30)
Manila (Makati), Philippines	1	8	(13)	3
Seoul, Korea	na	na	(8)	(4)

() = negative values are enclosed in parentheses, na = not available.

Source: Estimates based on charts from Jones Lang LaSalle.

given to preventing the collapse of the financial system from causing an economic meltdown. Because a financial system simply cannot function without confidence, depositors and investors must be reassured that there is no need for panic. Without such confidence, there can be no payment system, no safe haven for depositors, and no reliable source of credit to enterprises and individuals.

Governments typically resort to measures such as providing depositors (and often creditors) with full guarantees and assuring sufficient liquidity for banks to meet depositor demands for funds. Priority is often given to providing financial assistance to prevent bank failures—and the bigger a bank is, the more likely that the government will not let it fail. Minimizing adverse effects on employment and making credit more accessible to enterprises are also important considerations.

Fiscal considerations are typically assigned a high priority in resolution strategies. Policies are therefore likely to favor bank assistance programs. But government officials, with their limited time and resources, often tend to rely on overly optimistic assumptions. Bankers, as might be expected, almost always estimate the cost of rehabilitating their bank to be less costly than a liquidation or government-assisted sale to third-party investors.

Other considerations may influence policy. For example, there may be a strong reluctance to nationalize the banking system because of concerns that government-run banks would disrupt market-based banking. This concern is understandable since government-run banks in a number of countries have been used to fund political initiatives rather than private-sector needs, and banking services, skills, and regulation have deteriorated. However, not all countries are so averse to the “temporary” nationalization of troubled banks as part of bank bailout programs. The success of such actions will likely depend on the extent of the government’s operating control and the length of time controlling ownership is maintained. In general, less is better.

Still another factor that affects a resolution strategy is an inherent preference or requirement to retain domestic ownership and control of the banking system. Governments often rely on their banking systems to finance projects that would otherwise require fiscal budget allocation. Domestic ownership can also be a politically sensitive issue fueled by concerns that a country is selling out to foreigners. Last but not least, domestically owned banks are likely to resist increased competition from foreign banks. Such concerns are also likely to favor bank assistance strategies over assisted but involuntary sales to new investors. However, such preferences usually conflict with, and eventually give way to, the greater need to find strategic capital investors.

In a crisis, avoiding the risk of moral hazard, imposing market discipline, and even ensuring operational fairness and transparency are usually lower-priority objectives. This is not to say that countries are indifferent, as many countries have attempted to design programs that address such issues. Nonetheless, saving the system is the highest and most urgent priority, and compromises may have to be made where other objectives are concerned.

As a financial crisis and the risk of an economic free fall subside and the banking system stabilizes, priorities typically change. Governments now have more time and experience to evaluate their actions, and the risks are also lower. The public also has more time to assess the actions taken. The fiscal, social, and political implications of the government’s decisions are likely to be scrutinized very closely, and can often become very contentious. Government policies often shift from saving banks to resolving nonviable banks through greater use of interventions, involuntary mergers, or liquidations.

No matter which goals a government chooses to prioritize, the NPA resolution program must improve the overall health of the banking system and thus promote economic development. Experience has shown that there is no panacea or single solution for all problems. Each crisis is different, and

resolution strategies should reflect each country's unique environment. Several programs have been used in the past by governments facing systemic banking crises.

Nonperforming Asset Resolution Programs

A government typically takes one of three approaches to solving a bank's NPA problems, depending on their severity: (i) assist the bank, (ii) assist the debtor, or (iii) intervene and take over the management of the bank's assets. Each program affects the way in which NPAs are valued and serviced. The first two approaches tend to interfere much less than the third in the way that banks and debtors operate. Generally, the government intervenes when it perceives a bank's NPA problem to have become too unmanageable for the institution. In this case, a government-sponsored AMC is often established. The more directly the government involves itself in managing NPAs, the greater the likelihood that political concerns may diminish the efficiency of operations. However, governments are often better able to focus effectively on issues of fairness, transparency, and competitiveness.

In the next section, three basic approaches to resolving NPA problems will be presented as a general overview, with several examples from Asia, Mexico, Sweden, and US. Further information can be found in the appendices.

Bank Assistance Programs

In a bank assistance program the government facilitates the rehabilitation of a troubled bank. The assistance takes the form of regulatory forbearance or financial assistance, which may include the acquisition of nonperforming loans and assets.

REGULATORY FORBEARANCE

Regulatory forbearance occurs when the government eases regulatory rules to allow troubled banks to continue operating. Forbearance is a "hold" strategy used

when the government believes that problems can be resolved without making a financial commitment. It typically includes relaxing or waiving either or both regulations and accounting rules. The most common examples of regulatory forbearance concern central bank reserve requirements or prudential standards such as loan concentration limitations, minimum capital requirements, loan classification, and loan-loss provisioning. Accounting rules are relaxed when banks are allowed to defer loss recognition, for example, or to accrue unearned loan income or record intangible assets.

Many governments have resorted to some type of forbearance but with mixed success. In many cases, the problems have worsened, raising criticisms that the government did not act forcefully enough. Success is largely influenced by macroeconomic factors such as the strength of the economy. However, it also depends heavily on bank management. Experience has repeatedly shown that bank managers often find it hard to objectively assess the scope of their problems and react suitably. Also, managers desperate to salvage a sinking ship may worsen matters by taking on greater risks in an effort to improve earnings. Successful forbearance programs must include realistic operational targets for banks, a process for actively monitoring progress, and, if necessary, a credible contingency plan.

In Korea, the government relaxed the provisioning requirements for NPAs and for losses on banks' securities portfolios between 1995 and 1996. In Malaysia, the government carried out capital controls in September 1998, while progressively lowering statutory reserve requirements. It also relaxed restrictions on lending to the property and equity sectors. The Philippine government, in 1983, granted banks regulatory forbearance with respect to the requirement to maintain reserves against their bad loans. As was the case in the US, these East Asian attempts generally led to a further deterioration of banking assets. Very rarely does regulatory forbearance achieve the desired effect.

FINANCIAL ASSISTANCE

In addition to, or in lieu of, a forbearance strategy, a number of governments have provided financial assistance to troubled banks. Most governments, through their central banks, provide short-term liquidity assistance. In Malaysia, for example, the government recently injected about US\$1 billion into nine banking institutions in return for equity shares. Usually but not always, liquidity loans are provided on a short-term, fully secured basis, with little, if any, impact on the fiscal budget. A number of countries have also provided longer-term capital assistance, often in the form of debentures that may be convertible to a substantial equity interest in the bank. In many cases, assistance is provided to facilitate the merger of the troubled bank with a healthier bank. Such assistance typically involves earnings guarantees, asset loss protection, or the removal of distressed assets.

While providing financial assistance is a common practice in systemic crises, it is not without its critics. A common complaint is that financial assistance gives rise to moral hazard by protecting bad bank managers and owners against the consequences of their actions. Financial assistance transactions typically raise fairness questions about how banks were selected for assistance. In Indonesia, for example, the government's apparent decision to assist a major bank immediately stirred public concerns about political influence. Competing banks also complain that assisted banks enjoy favorable regulatory treatment, particularly in the case of banks where the government retains a significant ownership interest. In Sweden, for example, bankers complained bitterly that almost all assistance benefited a state-owned bank that used its government ownership and support to capture market share from private bankers.

Complaints against assistance largely depend on who gets it and how and when any ownership interests are sold. If the assistance is made to facilitate acquisition by a qualified and healthy bank in a competitive sale transaction, criticism is likely to be little and short-lived. The faster the privatization, the bet-

ter for market-based competition. The stronger and more independent the acquiring bank, the lower the risk of moral hazard. On the other hand, if assistance is given to merge one weak bank into another, the result can be a bigger problem, not a better bank, as a number of countries have found. In a systemic crisis, however, willing strategic investors can be impossible to find, for financial as well as political reasons. Domestic banks, fearful of competition, tend to oppose the assisted sale of troubled banks to foreign competitors. Still, several East Asian governments have moved to help contain losses and attract new strategic investors by reducing barriers to foreign entry. In the end, governments may see no other option than to assist in the consolidation of banks in the hope of improving efficiency and performance. While this course of action may not be the best, it may well be inevitable.

NONPERFORMING ASSET ACQUISITION

Financial assistance, as noted previously, often involves the removal of NPAs. Healthy banks usually do not want to take over another bank's NPAs because of the substantial risk and managerial effort involved. They want reassurance that the risks are measurable and small. Also, healthy banks are often reluctant to manage bad assets because of the drain on human resources as well as the potential distractions from new business development. Trying to sell assets to unwilling bankers can therefore prove to be an extremely long and often unsuccessful effort. The healthier the acquiring banks, the greater the loss guarantees are likely to be. Rather than sell assets at what are considered to be fire-sale prices, governments often replace these assets with cash or bonds. The bad assets are then either left with the management of the acquiring bank or moved to an AMC, an entity established to acquire, manage, and recover the nonperforming assets of troubled or failed financial institutions. In Korea, for example, the government "encouraged" some banks to take over smaller insolvent institutions, including some of their

problem assets, at fair transfer prices. In other cases, the government persuaded strategic foreign investors to acquire larger banks in return for its promise to purchase NPAs of merged banks and supply funds for recapitalization.

Debtor Assistance Programs

Another bank resolution program involves government assistance to borrowers in meeting their debt obligations. A number of governments facilitate or mediate debt restructuring negotiations. Others provide direct financial assistance. Some countries have established corporate debt restructuring agencies (CDRAs) to encourage voluntary meetings between creditors and debtors, and to oversee an independent assessment of a company's viability and worth. Other countries have established debtor assistance programs to ease the burden of decreased employment, rising interest rates, or devalued currencies. In a systemic crisis, such programs tend to be very popular politically and can be as necessary as bank assistance programs. On the other hand, they are not without risk. Assistance may be given inconsistently or unfairly. The programs can raise moral hazard and undermine a payment culture if not properly managed.

A number of East Asian countries have established CDRAs to encourage voluntary meetings between creditors and debtors. Table 7 lists several East Asian governments that have adopted a CDRA strategy. More details on debt restructuring can be found in Appendix Table A2.3.

Bank Intervention Programs

In resolving banking problems, governments often decide that the best course of action is to intervene and take control of a troubled bank, at least temporarily. This approach may be used when a bank is considered so insolvent or so complex that assistance is not a viable option. In general, intervention takes one of three forms, depending on the intended objective: formal intervention, informal intervention, or closed bank liquidation.

FORMAL INTERVENTION

Formal intervention typically refers to official government control of a bank and its operations until a permanent solution can be found. The bank may be placed under conservatorship, wherein new management is brought in to run the bank, or a limited-life, special-purpose "bridge bank" may be created to take over the operations, deposits, and assets of the failing

Table 7: East Asian Government Participation in Corporate Debt Restructuring, as of August 1999

Country	Corporate Debt Restructuring Agency	No. of Business Applications	Total Book Value of Applicants' Debt	No. of Companies Restructured (book value of restructured debt)
Indonesia (1998)	Indonesian Debt Restructuring Agency (INDRA) Jakarta Initiative	4	na	na
		251	US\$23 billion	24 (US\$3 billion)
Korea (1998)	Corporate Restructuring Committee	102	na	80 (US\$28 billion)
Malaysia (1998)	Corporate Debt Restructuring Committee	62	US\$9 billion	13 (US\$2 billion)
Philippines (1982)	Securities and Exchange Commission	35	na	3 na
Thailand (1998)	Corporate Debt Restructuring Advisory Committee	689	US\$37 billion	340 agreed (US\$20 billion) 52 actual (US\$3 billion)

na = not available.

Source: Corporate debt restructuring agencies.

private bank. The government-controlled bank continues to provide essential banking services but usually under strict operational guidelines. The basic objective is to rehabilitate and then privatize the bank. Shareholders' and other subordinated claims are usually paid only in the unlikely event that funds are left over after the final resolution and repayment of government funds. As may occur in an open bank merger, NPAs are normally carved out to facilitate privatization and placed under separate asset management.

In Japan, the government has partially relied on this strategy to resolve its banking crisis. If a takeover candidate for an insolvent bank cannot be found within a reasonable period of time, the government assumes control of the bank's operations by establishing a bridge bank. If no recipient bank is found within a given period to purchase the failed bank, it will be placed under liquidation.

One danger of this strategy is that the government may not be able to reprivatize the bank within a reasonable time frame, essentially nationalizing the bank and directing more credits. In Indonesia, for example, the government recently took over the operations of seven banks without clearly articulating its plans for their privatization.

INFORMAL OR DE FACTO INTERVENTION

An informal intervention is one where, rather than take official control of a troubled bank, the government works with the owners to find a solution to their problems. Typically, as has occurred in Mexico, this involves appointing a de facto intervenor to oversee bank operations. Selected members of senior management may be replaced and the authority of the bank's board of directors is effectively eliminated. The purpose of de facto intervention is the same as that of formal intervention. However, the process tends to be less disruptive to ongoing operations and public perceptions than formal intervention, although it also appears less transparent and may raise fairness concerns. The informal approach works best for banks with a significant underlying business value

which would be lost in a formal takeover. Thus, the process requires the ability to objectively identify such institutions as well as gain public acceptance.

BANK CLOSURE AND LIQUIDATION

A third intervention option is to close and liquidate a bank. This option is most appropriate for insolvent banks that have little intangible value or that present considerable risk if they are not closed, as would be the case if a bank had potential litigations or obligations that could mean large losses. Bank liquidations may be handled through purchase and assumption (P&A) transactions that look very similar to mergers between good banks except that the purchasers do not take on potential liability for any contested actions against the closed bank. In P&As, healthy banks agree to assume the deposits and other liabilities of a failed bank in return for its good assets and cash or notes from the government. As in an open bank merger, healthy banks are normally not interested in taking over distressed assets, even at heavily discounted prices. The bad assets are left behind to be resolved in liquidation or bankruptcy. Alternatively, if a P&A cannot be arranged, both good and bad assets would be assigned to an AMC.

This option is typically not viable if a country lacks the fiscal resources and the adequate legal and operational infrastructure to carry out the costly and complicated intervention. The laws of many countries restrict bank regulators from closing banks. Countries have used this approach with small banks, but very rarely with large banks as such an action could precipitate a bank run. In general, banks should be liquidated only as part of a comprehensive resolution strategy. The World Bank comments:

A strictly market-based approach to failed banks would call for their liquidation. Indeed, this is the best solution for isolated, small bank failures: clean surgery is often less messy than slow medicine. But where large banks suffer from a lack of public confidence and large segments of the banking system are insolvent, liquidation

only masks the problem. If banking fragility is a symptom of economy-wide problems, liquidation alone is neither practical nor useful. The resolution of systemic bank problems therefore must be part of an overall strategy to restructure and reform fundamental inefficiencies in the economy.⁹

COUNTRY-SPECIFIC RESOLUTION PROGRAMS

Table 8 highlights the bank resolution programs known to be employed in some selected countries.

The Asset Management Company

Over the past decade, unprecedented levels of NPAs have plagued the financial systems of many countries. In virtually all cases, governments have intervened to create, or assist in the creation of, AMC to manage the resolution of problem assets. One of the first government AMCs was the Federal Deposit Insurance Corporation (FDIC) in the United States, created nearly 70 years ago to insure deposits. Faced with failures to a degree never before ex-

perienced, the US Congress decided to centralize the liquidation of bank assets in FDIC rather than leave the process to separate court-administered bankruptcy procedures. Also, during the 1990s, other countries such as Mexico and Sweden established major government-owned AMCs. Several countries in East Asia have similarly set up AMCs to manage distressed or nonperforming assets.

The rest of the chapter will focus on government-assisted and government-supervised AMCs. First, the objectives of an AMC and the timing of its establishment will be discussed. Next, three basic AMC models and their specific characteristics, plus specific examples, will be analyzed. Finally, best-practice guidelines for designing and operating an AMC will be proposed.

Objectives and Conflicts

AMCs are established to acquire, manage, and recover illiquid or nonperforming assets from financial institutions. Relieving banks of the burden of NPAs should allow them to focus better on financing the development of new business opportunities that strengthen the economy. The transfer should help

Table 8: Country Resolution Programs

Country	Regulatory Forbearance	Financial Assistance	NPA Acquisition	Debtor Assistance	Bridge/Bank Conserv.	Liquidation
Chile	x	x	x	x	x	x
China, People's Republic of	x	x	x			
Hungary		x	x			
Indonesia	x	x	x	x	x	x
Japan	x	x	x	x	x	x
Korea	x	x	x	x	x	x
Malaysia	x	x	x	x	x	
Mexico	x	x	x	x	x	x
Philippines	x	x	x	x	x	x
Poland		x		x		
Spain	x	x	x		x	x
Sweden		x	x		x	
Thailand	x	x		x	x	x
United States	x	x			x	x

NPA = nonperforming asset.

Source: Barents Group, International Monetary Fund, and World Bank.

restore depositor and investor confidence and reduce the threat of market disruptions. AMCs should maximize recovery value while minimizing costs. They can also help build industry expertise in loan resolution, besides serving as a catalyst for important legal reforms in bankruptcy procedures and loan collection, as was the case in Thailand. AMCs can play an important role in developing capital markets through secondary asset instruments, as they are doing in Korea.

AMCs may obtain NPAs in negotiated transactions with banks, usually as part of a bank assistance program or as a result of bank interventions. The primary objective of creating them depends on one's viewpoint. The government is usually concerned with maintaining financial stability and stimulating economic recovery, while troubled banks are most concerned with survival. Typically, governments want to rehabilitate the financial sector while keeping fiscal costs and the risk of moral hazard to a minimum. Reconciling these twin objectives can be very challenging.

Almost without exception, troubled banks want government assistance but with few or no strings attached. They see AMCs as an important alternative for removing or reducing their NPA burden, but they want to obtain as high a price as possible for the NPAs to avoid further charges to their capital account. Eventually, banks may "voluntarily" sell their assets at a price they consider less than fair because the government or the marketplace requires them to bring their distressed assets down to a manageable level. However, the sale process often involves lengthy negotiations between the banks and the AMC which unfortunately delay the proper servicing of the NPAs during the interim.

Timing of Introduction

It is generally agreed that at some point NPAs can become such a serious drag on the ability of a banking system to serve its economy that the most practical solution would be to remove them and place

them in an AMC. However, there is disagreement on what that point is, or when it is reached. Several signs, however, indicate the need for action. One indicator is the level of NPAs held by financial institutions. (However, the level of manageability depends on the complexity and composition of the NPAs as well as the economic, financial, and political environment.) Another indicator of severity is eroding confidence, as evidenced by deposit outflows or declining stock values. Clearly, a country needs to move swiftly and aggressively to restore confidence when this occurs.

Still another indicator of severity is the inability or unwillingness of banks to make new loans, creating a credit crunch that worsens an economy's decline. A further indicator is a sharp decline in formerly robust real estate markets, evidenced by increasing foreclosures, falling rents and values, and a growing inventory of unsold properties.

Few countries have demonstrated the political, economic, and social will to establish an AMC before the problem reaches "crisis" proportions. Nonetheless, the earlier the NPA problems can be resolved, the sooner the banking sector can contribute to the sustained economic recovery of the country.

Asset Management Company Models

The term "asset management company" (AMC) is used here to refer to any organizational unit created to manage and recover financial assets acquired from troubled or failed financial institutions. Such entities include asset workout departments or units of banks, bank-owned subsidiaries or affiliated companies, private companies, and government-owned asset management agencies. The severity or systemic nature of a country's NPA problem usually dictates the NPA resolution strategy and the parameters for judging its success. A country's institutional, legal, and market conditions also influence the decision. Typically, the primary goal is to maximize net present value recovery in order to

minimize losses to either the selling bank or the government, depending on the AMC model used. Government-based AMCs may have additional challenges such as minimizing adverse market impact from the asset recovery process or helping to rehabilitate troubled banks and distressed borrowers. Objectives intended to promote economic and political stability can create conflicts within AMC operations and need to be prioritized.

For example, banks are likely to oppose AMC programs to sell assets rapidly at substantial discounts, out of concern over the implications on the value or management of their own assets. They usually argue that values will be driven down unnecessarily and at substantial cost to the government and the banking industry. In Mexico, despite encouraging results from the pilot program, innovative campaigns to sell assets in equity participation transactions with private-sector asset managers were put on hold because of criticism from the banking sector. In the US, industry concern played an important role in legislation designed to prevent savings and loan assets from being sold below fair value. Within a few months, the US decided to rely primarily on competitive marketing to maximize recoveries, rather than trying to maximize asset values by actively managing assets.¹⁰ Success for the US was measured not only by how far costs were kept to a minimum but also by how fast distressed assets were returned to private ownership. The prevailing view was that the sooner assets were sold, the faster the necessary market repricing and efficiencies would occur.

However, the relative size of the problem and the markets undoubtedly influence such strategies. In Sweden, for example, where NPA problems represented a much more significant part of the economy, greater emphasis was placed on maximizing value than on carrying out reprivatization. In Indonesia, Korea, Malaysia, and Thailand, the government AMCs are attempting to maximize value by actively managing assets.

In general, most bank resolution programs involve removing NPAs from normal bank operations. Usually, one of two basic AMC models—a bank-based model or a government-based model—is used. In the bank-based model, NPAs are transferred to a specialized bank department or “workout unit” or to a separate special-purpose organization affiliated with the “bad bank.” In the government-based model, on the other hand, a government-sponsored agency is created to acquire and resolve the bad assets. Many countries have established one or more of these structures to deal with their problem loans. The various approaches used in selected countries are listed in Table 9.

The AMC models used in these countries vary in their degree of centralization. Sweden and the

Table 9: Asset Management Company Models Used in Selected Countries

Country	Date Established	Workout Unit	Bad Bank	Government Entity
Australia	1990		x	
China, People's Republic of	1999		x	
Chile	1983			x
Czech Republic	1991		x	x
Finland	1991		x	
Ghana	1989			x
Hungary	1993		x	
India	1999		x	
Indonesia	1998		x	
Japan	1999			x
Kazakhstan	1995	x		
Korea	1998			x
Lithuania	1996			x
Malaysia	1998			x
Mexico	1994		x	x
Moldova	1995	x		
Norway	1991		x	
Philippines	1984			x
Poland	1993	x		
Slovak Republic	1991		x	x
Slovenia	1993	x		x
Spain	1980			x
Sweden	1991		x	
Thailand	1998		x	x
United States	1989			x
Venezuela	1994			x

Source: Barents Group, International Monetary Fund, and World Bank.

Table 10: Asset Management Company Type and Approach Used by Selected East Asian Countries

Country	Type and Approach
Indonesia (1997 to present)	<p>Type</p> <ul style="list-style-type: none"> Indonesian Bank Restructuring Agency (IBRA) – restructuring agency <p>Approach</p> <ul style="list-style-type: none"> Centralized approach IBRA has two main functions: to supervise banks in need of restructuring and to manage the assets it acquires in the bank restructuring process through its asset management unit
Korea (1997 to present)	<p>Type</p> <ul style="list-style-type: none"> Korea Asset Management Corporation (KAMCO) – restructuring agency <p>Approach</p> <ul style="list-style-type: none"> Centralized approach; special-purpose vehicle for the management and disposition of banking system nonperforming assets (NPAs)
Malaysia (1998 to present)	<p>Type</p> <ul style="list-style-type: none"> Danaharta – restructuring agency <p>Approach</p> <ul style="list-style-type: none"> Centralized approach; special-purpose vehicle for the management and disposition of banking system NPAs
Thailand (1997 to present)	<p>Type</p> <ul style="list-style-type: none"> Financial Sector Restructuring Authority (FRA) – rapid disposition agency Asset Management Corporation (AMC) – restructuring agency Radhanasin Bank (RAB)^a – restructuring agency Bank-Based Asset Management Company (BBAMC) Central Bank Asset Management^b <p>Approach</p> <ul style="list-style-type: none"> FRA – centralized approach; two main functions: evaluate finance companies' rehabilitation plans and sell their assets AMC – centralized approach; bidder of last resort for FRA's "bad" assets RAB – centralized approach; bidder for FRA's "good" assets BBAMCs – decentralized approach for commercial banks (private and state), including the transfer of Krung Thai Bank's NPAs to the central bank

^a RAB was initially created to manage the quality assets of the failed finance companies, leaving the bad assets to the AMC. In January 1998, however, the government announced that the RAB would no longer serve in this capacity, but would instead act as a commercial bank.

^b In September 1999, the government announced that Krung Thai Bank would transfer some of its NPAs to the central bank for management and disposition.

Source: Appendix Table A2.1.

United States are two developed nations that are deemed to have succeeded in working out their NPA problems. The US set up a government agency to manage the asset resolution process. Sweden used a somewhat more decentralized bank-based model coupled with close government oversight. Other countries such as Mexico and Poland have relied more extensively on decentralized bank-based AMC models. Table 10 indicates the AMC type and approach used in selected East Asian countries.

Broadly speaking, a number of factors should be considered when deciding what benefits each AMC model brings and what issues it raises, and which model is therefore most appropriate (Table 11).

BANK-BASED ASSET MANAGEMENT COMPANY

There are two bank-based AMC approaches: workout units and bad banks. In the case of workout units, the NPAs are moved to a separate bank department but remain in the bank's books. In the case of a bad bank, the NPAs are transferred to a separate affiliated organization that specializes in managing bad assets. The assets are no longer reflected in the bank's books, at least not on a nonconsolidated basis. Consolidation would likely occur for the bank or its parent company where a controlling interest in the bad bank is retained. The creation of bank-based AMCs may or may not involve some government financial assistance.

The bank-based approach offers several potential benefits: (i) use of in-house experience and knowledge about the NPA, (ii) maintenance of important banking relationships, (iii) strengthening of expertise in the resolution of bank NPAs, and (iv) establishment of new business relationships with new investors involved in asset workouts. Another very important consideration is that a bank-based AMC is likely to have more operational flexibility than a government entity. This flexibility can be particularly valuable in retaining qualified personnel and in structuring transactions.

Table 11: Asset Management Company Models

Item	Bank-Based		Government-Based
	Workout Unit	Bad Bank	Centralized
Consideration			
Extent of industry problems	Limited	Concentrated	Systemic
Need for government funding	None	Limited	Significant
Need for legal reform	Low	Medium	High
Need for special legal powers	Low	Low/Medium	Medium/High
Potential Benefits and Issues			
Synergies with originating bank	High	Moderate to High	Low
Conflicts with originating bank	High	Moderate to High	Low
Industry-wide coordination	Low	Low	High

Source: Barents Group.

However, while bank-based AMC's may have some benefits, they are not without operational problems. Because of their decentralized nature, bank-based asset recovery strategies may conflict with each other. While competition may benefit investors, there is a greater risk that the lack of coordination will result in lower recovery values. Where government funds are involved, some level of coordination is desirable to protect the public interest. Therefore, the greater the level of government support and the number of bank-based AMC's, the more persuasive the argument for government coordination. At some point, a centralized AMC would appear to be the most practical approach.

The bad-bank AMC approach may also lead to conflicts and a lack of objectivity within the bank. Bank management or loan officers may unduly influence the asset management and disposition process. Conversely, the AMC may attempt to influence its recovery rate by persuading the originating bank to buy back restructured but substandard loans. Also, the decentralized AMC provides greater opportunity for fraud and outside influence, particularly for larger credits.

Another consideration concerns the legal environment, particularly asset sales, collateral, and bankruptcy laws. If the legal environment is markedly unfriendly to lenders, governments may opt to push for necessary legal reforms. However, the process can be lengthy and controversial. Moreover, the AMC may have to be given special pow-

ers that exceed what is normally advisable. In the US for example, the Resolution Trust Corporation (RTC) was authorized to override state laws and set aside burdensome contracts. In Malaysia, the government provided its AMC with extensive authority to circumvent existing bankruptcy laws. While such powers may be beneficial, granting them to bank-based AMC's may be very difficult politically. Also, monitoring and controlling such powers to prevent misuse will be a major challenge. Where special powers are needed to override the judicial branch, a centralized approach may be the only practical alternative.

Workout Unit

In general, keeping distressed assets within the bank but in a separate workout unit has some advantages. Organizationally, loan officers are better able to focus on business development while dedicated specialists can focus on loan recovery strategies. Keeping the bad assets within the bank also provides an opportunity to develop in-house expertise as well as capture any spin-off business that results from loan workouts or asset marketing. Further, keeping the activity within the bank should help ensure orderly communication and data transfer between the loan department and the workout unit. But for these advantages to be realized, the workout unit should have both operational independence and performance-based employment incentives.

While there are some potential advantages, however, the major drawback of workout units concerns the remaining exposure to losses. Unless the NPA problem is measurable and relatively small, the workout unit will do little to rehabilitate the bank or restore confidence. If NPA levels are high, a workout model will not be effective without new capital or financial assistance. Once government assistance is provided, safeguards should be instituted to ensure fairness, consistency, and objectivity.

The workout-unit approach was adopted in Poland in 1993. The government instructed largely state-owned banks to transfer to separate workout units their assets that were classified as losses or doubtful assets, representing an estimated 30 percent of total loans. In return, the government provided financial assistance to cover loss provisions. It granted the banks special powers to negotiate workout agreements with debtor enterprises on behalf of all creditors. If a voluntary debt workout schedule could not be reached within one year, the banks were required to file for bankruptcy for the firm, liquidate the firm, or sell the NPAs. Within a year, nearly 98 percent of the larger loans had been restructured. However, the World Bank estimated that 15–20 percent of the workout cases did little more than delay loss recognition.¹¹ It is questionable whether the Polish model would work for countries like Indonesia and Thailand, where NPA levels are much higher and assets are widely dispersed and involve mostly the private sector.

Bad Bank

Instead of creating a workout unit, banks may be encouraged by the government to set up bad-bank AMC. As incentives, the government might allow a more optimistic valuation of transferred assets; not require consolidation for regulatory reporting and capital purposes; or provide financial assistance to facilitate the transfer. Frequently, the government takes a substantial ownership interest in the rehabilitated “good bank.”

Placing the NPAs in a separate but affiliated entity does not cancel the previously mentioned issues regarding resources and expertise but it allows the bank and the AMC to focus more on their primary mission. Also, it creates two potential sources of funds to repay any financial assistance from the government. One is from the sale of the bad-bank AMC or its assets, and the other is from the eventual sale of shares in the good bank.

The bad-bank AMC also raises the same concerns about expertise, objectivity, incentives, and the granting of special powers, noted with the workout-unit model. Moreover, relying on several bad banks makes it more difficult to coordinate asset marketing or packaging options and precludes the operational economies of scale that a centralized AMC would offer. Besides, uncoordinated bad banks competing to sell in a buyer’s market are likely to intensify a downward spiral in asset prices.

As noted earlier, governments may need to provide financial assistance to persuade banks to set up AMC affiliates. In Thailand, the government has indicated that budgetary constraints prevent it from setting up a centralized AMC for banks as it did for the finance companies. Banks have therefore been encouraged to set up their own AMCs, but so far the response has not been encouraging. Only a handful of banks have begun to plan for such a strategy.

In Sweden, two AMCs established by the government to separately take over the assets of two banks were eventually merged to take advantage of efficiencies and economies of scale. The resulting entity, known as Securum, closed in 1997 after five years of operations. The government provided financial incentives and operational independence to attract private-sector experts to manage Securum’s assets. Securum created several subsidiary organizations to suit different asset types and locations, and its strategy included the privatization (full or partial) of these operations. Privatization has been taking place, but its extent is not known.

In the People's Republic of China (PRC), the government recently announced the creation of a bad-bank AMC to take up to US\$36 billion in assets from the China Construction Bank. The government hopes that the AMC will serve as a model for the other three large state banks. The bad-bank approach is believed to have been chosen because the government feared that the amount of NPAs in the system was too large for a centralized AMC to handle. As in Sweden, the four AMCs are likely to be ultimately centralized to take advantage of closer industry cooperation, efficiencies gained in systems implementation, and economies of scale in asset valuation, management, and disposition.

If the NPA problems in a country are indeed large and widespread, a centralized approach may be a better option. Establishing several bad banks may ease some of the pressure on both government and banks to resolve the NPA problem. However, the experience of other countries shows that governments must offer some sort of incentive to create separate bad banks. Providing financial assistance can raise difficult political and operational issues. Whichever approach is used, the strategy needs to be carefully thought out. Having to redo the design, implementation, and operation of AMC strategies will increase the ultimate cost of resolution.

GOVERNMENT-BASED ASSET MANAGEMENT COMPANY

The more systemic the NPA problem, the greater the need for a government-led, centralized approach. A centralized strategy may also be used when bank management is not capable of operating a bank-based AMC. A government generally employs this strategy as part of a bank recapitalization/restructuring program. The government carves out the NPAs from the banks being restructured and replaces the bad assets with government bonds on the banks' balance sheets. The NPAs are owned by the government and may be managed directly by the AMC, partially contracted out to private managers, or even left with

the banks themselves to service. The AMC may be a special-purpose entity designed solely to acquire, manage, and recover NPAs, or it may also have other functions like deposit insurance or bank recapitalization. Because many centralized AMCs are formed in a crisis, the government is often pressured to enact legal and regulatory reforms and may grant the AMC significant loan recovery powers.

Centralizing NPA problems in a government agency offers certain advantages. From an operational standpoint, the government AMC should be able to achieve certain economies of scale in hiring and training appropriate staff and building management information systems (MISs). Centralizing asset management and disposition functions should facilitate asset packaging and marketing, and ensure consistency and transparency within the AMC. Also, the risk of different bank-based AMCs competing to drive down sale values should be reduced. The greater the number of institutions, the more extensive the debtor interrelationships, and the more similar the assets, the greater the need for government coordination and oversight. On the other hand, a government AMC usually has too little flexibility in its compensation structure to attract qualified personnel or provide performance-based financial incentives. Also, concerns about public perceptions may unduly slow decision making.

A government AMC should be in a better position to develop strategies that maximize recovery value. These strategies might include holding onto certain assets in order to achieve better pricing, providing funding to rehabilitate a business or an asset, or even restructuring entire business sectors. The danger here is that losses will increase if decisions are based more on power and politics than on sound business judgment. In Malaysia, the government-based AMC plans to enhance asset values by giving the state a greater role in owning and managing certain businesses, a situation that may impede the development of the private sector. From a legal standpoint, a government-sponsored AMC should be in a better position

to receive extraordinary asset recovery powers that politically could not be given to the private sector.

In April 1999, Japan announced that it was establishing a government-based AMC, the Resolution and Collection Corporation (RCC), modeled after the US RTC. RCC was created through the merger of the Resolution and Collection Bank and the Housing Loan Administration Corporation, which had both tried but failed in the past to recover the NPAs of the financial system. Unlike its predecessors, RCC is empowered by new legislation to acquire NPAs from healthy institutions, not just failed ones.

HYBRID MODELS

Several countries have used a hybrid model in designing, implementing, and operating AMCs. In Mexico, the government created a centralized AMC to acquire NPAs, but asset operations were very decentralized. The selling banks were retained to service these assets with relatively little oversight and coordination. Despite incentives to encourage banks to maximize recoveries, progress in the speed and amount of recovery has been very slow and subject to much criticism.

In the Philippines, the government recently outlined a proposal for a national AMC that would be a majority-owned, private-sector asset management firm. The Department of Finance has reportedly asked three government banks to contribute up to 49 percent of the equity, with the rest to come from the private sector. In theory, an approach that combines limited government funding and passive ownership with private-sector ownership and expertise could offer substantial benefits.

India is trying out a coordinated private-sector option. Five commercial banks recently announced plans to create a privately owned AMC. The AMC would buy NPAs from the banks at prices to be negotiated. If successful, this approach could help marshal limited asset management expertise, create economies of scale, and expand marketing options. However, much will depend on the satisfac-

tory resolution of pricing standards and funding requirements.

Recommended Asset Management Company Guidelines

Countries have used different strategies to resolve NPA problems in their financial sector. Their experience suggests that there is no single “best practice” approach for all situations. However, when implementing an AMC strategy, governments should consider the following guiding principles.

Asset Management Company Timeline

A common mistake in establishing any organization is to underestimate its complexity and the time and effort required. Before implementing an AMC strategy, a country should first diagnose the nature and extent of its banking problems. The findings should be considered when deciding what type of AMC to use. While not all-inclusive, Table 12 outlines some key tasks and general time frames for the design, implementation, and operation of an AMC. Of course, much depends on the size of the problem, the level of government and private-sector expertise in managing distressed assets, and the level of development and sophistication of the market.

The design phase is the most critical as early design decisions can greatly influence the course the AMC takes and its ultimate resolution costs, in both financial and political terms. This phase must be executed carefully to ensure that the strategy and design of the AMC are built on as clear an understanding of the problem as possible. For example, over-emphasizing early NPA disposition before the potential NPA inventory is understood can lead to unrealistic expectations and dissatisfaction on the part of government, investors, and the public in general. This is not to argue that the asset disposition process should be delayed unnecessarily. An orderly and com-

Table 12: Asset Management Company Timeline

Phase 1—Planning (0–6 months)	Phase 2—Start-Up (4–8 months)	Phase 3—Operations (3–5 years)
Strategic Plan <ul style="list-style-type: none"> • Measure size and impact of NPA problem • Assess funding needs and sources • Develop resolution strategy and goals • Design governance structure • Assess legal environment and needs • Draft and propose necessary legislation • Develop asset recovery principles Operations Plan <ul style="list-style-type: none"> • Design organizational structure for operations • Establish valuation/pricing principles • Develop communications strategy • Assess MIS needs and alternatives • Develop staffing strategy and standards • Establish outsourcing standards 	<ul style="list-style-type: none"> • Develop staffing plans and position descriptions • Recruit, select, and train staff • Design NPA valuation process and procedures • Design asset transfer process flow • Establish data collection process and procedures • Implement MIS and accounting interfaces • Develop operating manuals 	<ul style="list-style-type: none"> • Collect and disseminate data • Prepare asset management and recovery plans • Carry out market outreach programs • Value and acquire assets • Service assets • Sell assets • Carry out loan workouts • Undertake asset funding and enhancement • Carry out outsourcing and monitoring • Implement financial monitoring and reporting

MIS = management information system, NPA = nonperforming asset.
Source: Barents Group.

petitive disposition process will strengthen investor confidence in the commitment to resolve NPA problems and can provide momentum to the recovery process. However, it is very important that operational strategies be carefully designed and that the government use credible and experienced people who understand the issues and can objectively balance government goals with those of bankers and investors.

LEGAL CONSIDERATIONS

For the AMC to operate efficiently, the resolution strategy should also include assessing the legal infrastructure—the efficiency of the courts' case management system and the adequacy of bankruptcy, tax, property ownership, collateral, and foreclosure laws. The government should ensure that appropriate laws are in place to permit the foreign ownership of assets. Finally, it should create a framework for debt workouts.

Many East Asian countries lack the type of legal infrastructure that is necessary for quick recovery. While Korea has a court system that is considered to be relatively efficient in enforcing collateralized claims, many other East Asian countries have laws that are seen as time-consuming, inefficient, and unpredictable. The mechanism for collateral registration is often poorly developed, particularly for chattel mortgages. On the other hand, there are legal re-

quirements that do not seem to serve a substantive purpose and that can impede the development of market-based reforms. If the political system does not facilitate these legal reforms in the given time, the government should grant the AMC temporary special legal powers. (Some of East Asia's key bankruptcy and foreclosure issues are summarized in Appendix Table A2.5.)

UNDERSTAND THE PROBLEM AND THE ENVIRONMENT

Before establishing an AMC, a country should first diagnose the nature and extent of its banking problems. It is extremely important to understand the problem before designing a solution. The liquidity and solvency of the financial sector, including the scope and complexity of NPA problems, should be carefully evaluated. The nature of corporate debt should be assessed. For example, in many East Asian countries, foreign creditors hold significant portions of domestic corporate debt. In Indonesia, for instance, foreign creditors hold 60 percent of domestic corporate debt, according to World Bank estimates.¹² The holding of corporate debt by foreign creditors can impede an AMC's efforts to restructure NPLs to domestic enterprises. In some cases, the acquisition of foreign-held debt by an AMC could expedite resolution. However, AMCs are not always authorized

to acquire foreign-held debt. While the authority to acquire NPLs held by foreign-held institutions should be tightly controlled and limited, in certain cases the acquisition may be economically justifiable. For example, when foreign creditors own a relatively small share of a domestic corporation's debt but effectively have the authority to block a restructuring program, it may make sense for the AMC simply to "buy out their debt."

A program of bank reviews conducted by qualified experts should be implemented very early in the process. Factors to be reviewed should include not only the banks' financial condition and management but also their experience and capability to manage loan problems. The findings of these reviews should be considered when deciding whether to use bank- or government-based AMCs. Action plans should be based on the results. In Thailand, although the government acted promptly to resolve the NPA problems of finance companies, comprehensive strategies still have to be developed for dealing with the pervasive problem of NPAs in the banking sector.

In addition to the financial problem, a government should also consider the country's cultural, political, and legal environment when designing an AMC strategy. This includes public and investor understanding and support for the strategy, creditor attitudes and experience in working with distressed debtors, debtors' attitudes toward paying debts, and the court's attitude toward creditors. The political environment relative to the level of consensus needed to resolve the crisis and the nature of directed lending has to be taken into account. Also, it is important to assess the relationship of the loan problems to the economy, including the role of excessive leverage in the crisis and the degree to which the crisis is depriving viable businesses of access to credit. Finding the right balance between providing too much credit and providing too little can be very challenging, particularly when an AMC is assigned the task of minimizing asset losses and supporting business recovery.

DEVELOP AND IMPLEMENT BUSINESS PLANS FOR PROMPT ACTION

Structuring solutions usually involves a number of steps that take more time than what was anticipated or is desirable. Action plans must be developed and implemented to educate the public, garner political support, and enact necessary legislation. At the same time, the country should begin to develop a business plan to guide the activities of the AMC. The business plan should address both the structural design and the operations of the AMC. The sooner this plan is developed, the better. An AMC is likely to need an eight-month "planning" and "start-up" period to design policies and procedures, inventory assets, build systems, and hire and train appropriate personnel.

On the other hand, governments must act promptly to resolve the NPA crisis. A recent IMF study concluded that countries that acted within one year of the emergence of significant credit problems have had the most success in resolving their banking crises.¹³ In Indonesia, for example, the government has come under increasing criticism for not addressing the banking problems early enough. In 1993, the percentage of NPAs to total banking assets in Indonesia was estimated to be 14 percent. By March 1999, this figure had grown to about 70 percent.

RETAIN INDEPENDENT AND OBJECTIVE EXPERTISE

Many governments have retained foreign expertise to assist them in diagnosing the problems in their financial sector, developing an AMC strategy, starting up operations, training local resources, and transferring expertise. It is important not only for governments to assess their need for expertise, foreign or otherwise, but also for them to understand the motivations of their advisers because the advice given may not always be objective and neutral. Potential conflicts of interest can thus be avoided. In East Asia, for example, several investment banking firms that offered strategic advice on how to package certain

asset portfolios were also on the buy side. Although many investment banks offer sound design and operational advice, governments should not rely upon these advisers to ensure that internal firewalls are in place. From experience, it has been observed that the integrity of these firewalls is, at times, suspect. To avoid a conflict of interest, or at least the perception thereof, the selection of foreign consultants should be made on a competitive basis.

SELECT AND COORDINATE THE NONPERFORMING ASSET RESOLUTION STRATEGY AND THE ASSET MANAGEMENT COMPANY MODEL

The selection of the most appropriate AMC model, or a variant thereof, should take into account the severity or systemic nature of the NPA problem and the country's institutional, legal, and market conditions. In general, the more pervasive the problem, the greater the need for governments to play an active role in the resolution of distressed assets. This might involve the creation of one or more government-based AMCs. However, the number of AMCs should be limited to avoid public confusion and contradictory practices. In addition, although competition between AMCs may be healthy, it may also be counterproductive.

In Malaysia, for instance, a single AMC leads and coordinates the asset management and recovery process with other government agencies. In Thailand, on the other hand, the government created several AMCs without providing adequate guidance and coordination. As a result, the Thai AMCs do not appear to be working in harmony to resolve the country's NPA problem.

The existence of widespread NPA problems does not preclude the establishment of bank-based AMCs in lieu of, or in addition to, government agencies. However, decisions to create bank-based AMCs with government assistance should be made only after careful evaluation of the potential for abuse and public criticism. Thailand is currently experi-

menting with this dual strategy. However, experience has shown that when an NPA problem is large and systemic, a single centralized, government-based AMC is most effective in achieving efficiencies and economies of scale.

Asset Management Company Structural Design

Within the business plan, the government should finalize the AMC's structural design and operations in consultation with its advisers. The best-practice guidelines discussed below are meant for those AMC circumstances where public funding is necessary and government participation is required.

ESTABLISH CLEAR OBJECTIVES

Clear objectives should be established for AMC governance and operations. The objectives should stress transparency, fairness in transactions, and efficiency in operations, and should be based on realistic time and recovery expectations. The objectives should support maximum coordination and clarity of governance. Potential conflicts between objectives, such as having to assist borrowers, expedite sales, and maximize values, should be minimized as much as possible. The AMC should be a special-purpose vehicle. Having multiple responsibilities is challenging for any organization, particularly a newly established AMC faced with carrying out a difficult and often unpopular task. Without clear goals, the AMC will have difficulties prioritizing tasks and operating independently.

Where conflicts do exist within the same organization, priorities should be established. The relative importance of value maximization compared with loss minimization should be decided early. The timely return of assets to the private sector at fair values should be assigned a high priority along with minimizing market disruption or interference. Government-subsidized AMCs should be prohibited from speculative or unsubstantiated risk taking. The AMC should be focused on the recovery of the

assets of financial institutions and not on its own survival or expansion.

Finally, objectives should encourage an orderly termination of the AMC's activities at a legally established "sunset" date for privatization. Parliamentary approval should be required for an extension. In most of the East Asian countries surveyed, government-based AMCs do not have a legally fixed date for ceasing to operate. Although many of the governments argued that they could not predict how long the recovery would take, this open-ended policy may discourage the timely termination of operations. Once the nonperforming assets have been brought down to reasonable levels, the banking sector should be sufficiently healthy to manage them.¹⁴

PROMOTE TRANSPARENCY AND CONSISTENCY

The public as well as investors must understand and support the AMC's initiatives. This is especially important in countries experiencing political uncertainties. Priority should be given to explaining what is being done, why, and how. The AMC should look for ways of developing market outreach programs. Operational policies and plans should be made public to help promote transparency and consistency. An AMC should regularly provide information on its progress. Financial results should be published, using internationally accepted accounting practices, and should be audited by an independent entity. Sales transactions should be broadly marketed and negotiated sales should be avoided. Many AMC transactions will likely involve negotiations with debtors which, for practical reasons, cannot be opened to the public. Nonetheless, policies should be developed to promote confidence in the integrity of the process. These would include guiding principles and approval procedures to be applied in such negotiations. Similar steps should be taken for other aspects of AMC operations. For example, the selection criteria and process for hiring administrators to manage assets should be made known.

Lack of transparency can often result in a conflict of interest, or at least the appearance thereof. In Indonesia, for example, the government, while stating that the AMC had developed guidelines for its decision making, has not made these guidelines known to the public because of the many nontechnical dimensions of the NPA problem. In Malaysia, the AMC plans to issue semiannual operating reports that provide information on asset acquisitions and recoveries, but does not plan to make its board-approved operating policies public. In addition, it does not publish the criteria for the selection of special administrators, appointed officials who take over and manage a debtor company. Operating policies are also not published in Korea and Thailand. In the US, on the other hand, the Resolution Trust Corporation maintained a public reading room where most operational and financial documents could be viewed.

MINIMIZE POTENTIAL CONFLICTS OF INTEREST

Ethical standards should be developed for employees and consultants to promote confidence in the integrity and fairness of AMC operations. At a minimum, employees and their interests should be prohibited from buying AMC assets, except under very strict public guidelines. Employees should be barred from establishing any employment or business relationships with potential investors or contractors. As mentioned above, financial consultants should be prohibited from bidding for specific asset transactions that they helped to structure.

PROVIDE ADEQUATE OPERATIONAL AUTHORITY

An AMC's activities are likely to be controversial and subject to criticism which can impede progress. Therefore, an AMC must have the independence and authority to operate efficiently. At the minimum, this includes the ability to hire and fire employees and to provide competitive compensation to attract

quality personnel. Other important powers include the power to employ private-sector contractors; to spend funds to maintain or enhance asset values where appropriate; and to provide financing, equity participation, and limited warranties to facilitate sales transactions. The AMC might also be authorized to borrow money and issue government-backed debt. Such authority should, however, be limited and closely monitored. Even with bank-based AMCs, the government should have some oversight role, depending on the extent of its involvement.

The Philippines' experience in NPA recoveries shows the importance of operational independence for an AMC. The country's AMC's operations are overseen by a board of trustees, which in turn is supervised by the Committee on Privatization (COP), a cabinet-level body headed by the Secretary of Finance. The Asset Privatization Trust (APT) has limited operational authority as the COP must approve all sales transactions.

PROVIDE FOR OBJECTIVE OVERSIGHT AND GOVERNANCE

While an AMC should have a great deal of operational independence, provisions should be made for balanced, nonpartisan government oversight. Regardless of whether several bank-based AMCs or a single AMC is established, the government should consider appointing an independent oversight board to ensure transparent, consistent, and efficient operations. To give the board credibility, it should include a mix of senior government officials and well-regarded representatives from the private sector. Its members might include officials from the Ministry of Finance and the central bank; one or more representatives from the World Bank or the Asian Development Bank; and private-sector representatives from the financial and industrial sectors. The board should not be directly involved in the daily operations of the AMC and none of its members should participate in transaction decisions or be affiliated with specific AMC cases. The board's re-

sponsibilities should be limited to hiring (and firing) AMC management and approving proposed operating and capital budgets, as well as operational policies and strategies. Other responsibilities could include approving rules of ethics to prevent operational conflicts of interest and implementing programs to monitor compliance with approved policies, budgets, and strategies. Finally, in order to educate the public, the government, and AMC staff, meetings of the oversight board should be open to the media and its decisions published.

PROVIDE ADEQUATE FUNDING

For centralized AMCs, the government must provide adequate funding, both for the acquisition of assets and for the operations of an AMC.

Purchase funding. With regard to the funding of NPA acquisitions, authorizations should allow for changes in asset volume and pricing. Rates and maturities should be consistent with asset pricing and recovery strategies. Funds should be recoverable and the expected net present value of recoveries should at least cover the funding principal and interest. Priority should be given to cost and budget impact. Domestic funding is likely to be the most cost-effective source. With domestic funds, the government primarily has two choices: direct bank recapitalization, or NPA purchase in exchange for bonds. Although direct bank recapitalization would improve the banks' balance sheets, it is often economically and politically unfeasible. The benefits of swapping NPAs for government-guaranteed bonds include the following:

- Selling institutions are likely to be the most flexible, as market rates would be more costly;
- Bonds could be eligible for discounting at the central bank to meet liquidity needs;
- Budget impact is less immediate;
- Bond interest could be factored into asset pricing; and
- Repayment timing could be related to the expected timing of recovery.

A second source of purchase funding would be the private sector. The AMC could be granted limited authority to raise private-sector funding, but not including retail deposits. Finally, foreign funding may also be used, although this source is generally the most expensive. Under this method, government-backed bonds secured by acquired NPAs could be issued to institutional investors. In the East Asian countries surveyed, government-guaranteed bonds covered over 90 percent of funding. With a bank-based approach, the level of government funding should be minimal. If the problem requires substantial resources, the government should consider creating a government-based AMC.

Operational funding. Funds for start-up and operations should cover operating expenses, for such items as salaries, equipment, and systems; asset maintenance to preserve asset values; and asset enhancement to fund viable businesses where appropriate. Potential sources of operational funding include the issuance of equity to member banks; private placements to sophisticated investors; and borrowings from the government, multilateral donor agencies, or participating banks (channeled directly to an AMC or to an AMC-backed business or project). Public equity offerings should be discouraged unless values have been clearly established.

PROVIDE FOR SPECIAL LEGAL POWERS

An AMC must have the necessary legal authority to expedite the acquisition, management, and recovery process. An obvious but nonetheless important power is the right to acquire and transfer ownership of loans without debtor approval. In many countries, as in East Asia, such authority requires special legislation. Other special powers may be appropriate provided that they are consistent with overall government objectives. These powers might include removing loans from bankruptcy proceedings, setting aside unreasonable or burdensome contracts, and disavowing improper changes in loan terms. Other special powers to consider include overriding obstructive state or provincial laws,

gaining exemption from court restraining orders for sale transactions conducted in compliance with established AMC policy, and setting aside employment regulations governing state enterprises to be privatized. While such powers may be important during a crisis, they should have sunset provisions limiting their life. Also, the oversight board should closely monitor the use of special powers to minimize confusion or abuse.

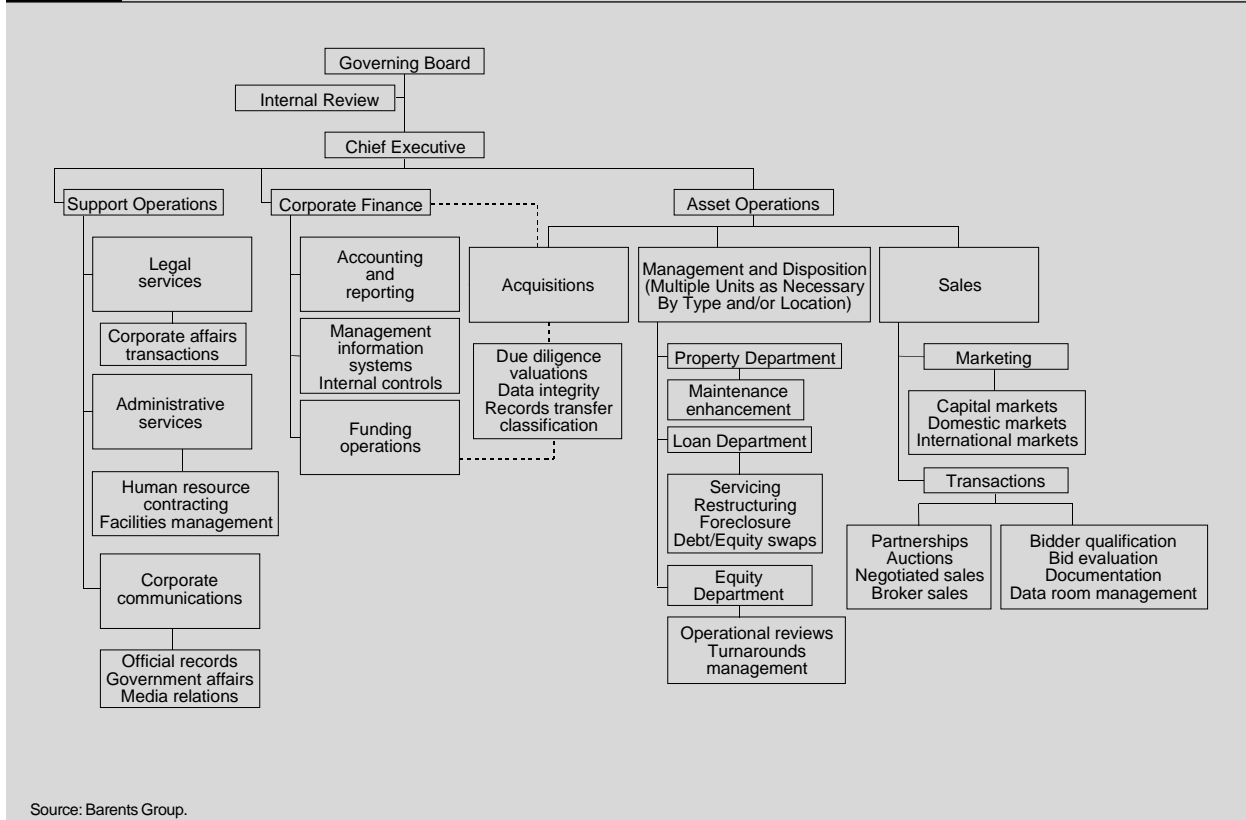
In Malaysia, the government granted the centralized AMC special powers which included the authority to set aside contractual obligations, to remove creditors from court bankruptcy protection, and to engage in transactions without the risk of court restraining orders. Although clearly beneficial to the AMC's operations, the granting of special powers to control all of a debtor's obligations, including those made subsequent to the NPA purchase, raises concerns regarding the potential impact on domestic lending and foreign investment. Although special powers enable the Malaysian AMC to resolve an NPA crisis more effectively, proper safeguards should be put in place to limit the time frame in which the AMC can use those powers.

Asset Management Company Operations

While all aspects of AMC operations are important, several deserve special consideration. These include the design and staffing of its organization, its asset valuation and management procedures, and the quality of its management information systems.

DEVELOP BUSINESS PLANS

To succeed, an AMC must adopt and implement strategies that are consistent with its established operating policies and priorities. These strategies should include business and action plans that define objectives and performance benchmarks. Responsibility for accomplishing objectives should be clearly assigned to those responsible for developing strategies. Standards and procedures for acquiring, recording, and controlling assets should be part of the plans.

Figure 2: Sample Organization Chart for an Asset Management Company

ORGANIZE FOR EFFICIENT AND EXPERT OPERATION

Positions and responsibilities. An AMC should clearly identify organizational roles and responsibilities. It should have an organization chart that defines functional and decision-making responsibilities including the role of an operating committee. Figure 2 is an example of a generic AMC organization chart.

Ethical and efficient operations should be promoted. Streamlined delegations of authority should be developed, with approval procedures related to the size or materiality of the transaction. Internal controls should be designed to minimize partisan, self-serving, or corrupt influences. Major decisions should require approval by the operating committee. Records of committee meetings, as well as any supporting documentation, should be kept for subsequent review. In addition, an independent process of monitoring compliance with established ethics, fairness, and transparency policies should be established.

Human resource development. AMC staff will require expertise in asset management, including asset appraisal, property management, and the conduct of workouts. Experience in banking, law, public relations, accounting, and marketing will also be required. The AMC should be able to provide competitive compensation, preferably including performance-based incentives. Developing the necessary employee resources will also necessitate specialized on-the-job and classroom training programs, procedure manuals to ensure operational consistency, and employee ethics standards.

Private-sector expertise. Plans should be developed to make the best use of private-sector expertise. Areas where the use of such expertise would result in quicker and more efficient operations should be identified, and transparent procedures should be developed for selecting the best-qualified consultants. Joint ventures with foreign partners to outsource the management and disposition of NPAs should be given

serious consideration. The use of contractors offers several advantages, particularly when the AMC is government-run. These advantages include increased flexibility in compensation arrangements, greater ability to leverage limited employee resources, and greater speed and flexibility in both “ramping up” and downsizing with changes in the asset inventory. Still another potential benefit is the further distancing of transactions from political influence.

PROMPTLY EVALUATE AND IMPLEMENT MANAGEMENT INFORMATION SYSTEMS

The MISs should be assessed very early on and plans should be developed for creating an integrated MISs environment that fully supports management’s needs. MISs needs should be assessed by experts who have both an understanding of MISs needs and best practices worldwide and the capability to adapt those needs and practices. The information systems should include general and subsidiary ledgers, cost accounting, and asset valuation to support both financial reporting and asset management, loan servicing, and asset management monitoring. The design of the MISs should consider the systems’ probable life cycle and allow for regular reevaluation. The most immediate need is an inventory system that can handle the anticipated data volume; is user-friendly when it comes to sorting and updating; can facilitate electronic data transfers from originating or serving institutions; and can integrate financial management system needs with the overall MISs strategy.

VALUE ASSETS CAREFULLY AND CONSISTENTLY

The value assigned to AMC assets can have a tremendous impact on how the AMC operates. Valuation techniques are needed in order to make informed decisions regarding asset purchase price as well as the timing and the nature of sales transactions and other sales strategies. In general, valuation policies must relate to disposition strategies and should be based on realistic values. A number of sales tech-

niques are possible. They include portfolio sales, open-outcry and sealed-bid auctions, securitization, and equity participation transactions. The valuation process can also influence other decisions, such as whether or not to provide seller financing or to fund asset enhancements (or even the operations of a business). Valuation should play a major role in deciding whether or not to engage in debt-for-equity swaps with borrowers or in determining the funding cost of providing equity participation. Additionally, asset valuation procedures are necessary in monitoring and reporting on the financial condition of the AMC.

Standards and procedures. The first step in valuation is to collect the necessary information about the loan and then to stratify and prioritize the assets by size, industry, operating condition, and location. Sources of information include loan files, bank files, service providers, bankruptcy procedures, the trustee/receiver, feasibility studies, and appraisals. The AMC should specify the minimum level of information desired for each category of loans, but the requirements should be practical and should consider the availability of information and asset value. It should require selling banks to furnish asset information to guide better-than-“liquidation” pricing. The type of information that is necessary for analysis may include rescheduled loan payment and workout plans, payment history, rank of obligation in priority of claims, property descriptions, and description and value of collateral. With this information, the AMC should determine a valuation methodology, based on asset categories and recovery strategies, and then develop a mathematical model to derive the investment value. The more significant an asset, the more rigorous the valuation effort should be. The AMC should develop due-diligence material, ideally in a standard format, taking the asset information into account.

Valuation standards. In principle, the AMC should base its pricing and asset disposition decisions on the alternative that realizes the highest net present value, considering all internal and external operating

costs. Specifically, these guidelines should be followed:

- Net-present-value (NPV) calculations should be used in determining the best asset exit strategies;
- A standardized approach should be developed for applying discount rates to NPV calculations;
- NPV discount rates should reflect credit risk, the value of collateral, guarantees, and other enhancements;
- Standards should be developed for estimating the timing of cash-flow recoveries;
- Standards should be established for defining recoveries, particularly for restructured loans and equity positions;
- Standard direct/indirect overhead rates should be developed and factored into NPV calculations; and
- NPV results should be evaluated for consistency with investor return requirements and overall disposition goals.

The broader or more liquid the market is, the easier it becomes to determine value. One can reasonably estimate an asset's value by looking at prevailing prices, with an appropriate level of marketing. However, the poorer the market conditions or the more unusual the asset, the more difficult the valuation. For most illiquid assets, estimating the amount and

timing of future expenses and collections requires a considerable amount of educated "guesswork."

Models and systems. The AMC should develop valuation models utilizing funding costs and required returns, cash-flow assumptions, net-present-value discount rates, valuation formulas and assumption standards, loan classification categories, and information requirements. As indicated in Table 13, the AMC may choose different valuation techniques depending on the circumstances.

Valuation systems should also be developed and implemented for inventory, asset management, and loan servicing. The inventory system will enable the AMC to efficiently stratify its assets for management and sales. The asset management system will assist the AMC in the effective pricing, management, and disposition of assets in a manner that maximizes their value. The loan servicing system will provide the AMC with a system for managing the collection of payments, the placement of hazard insurance, and the payment of taxes. Servicing also consists of such operational procedures as customer service, loan administration, loan accounting, investor and regulatory reporting, and delinquency analysis.

Realistic pricing. The value assigned to the assets being transferred to the AMC will have a major impact on the AMC's success in managing them. The transfer values should be set low enough for

Table 13: Valuation Models

Approach/Model	When to Use	Process
Market	AMC ownership of an operating business with comparable traded companies	Collect and analyze market information, establish price/earning multiples, and apply to the firm's normalized earnings
Adjusted Book Value (Liquidation)	AMC ownership of a struggling business with no comparables and rapid disposition is planned	Adjust the firm's reported assets and liabilities to approximate the market value of an operating business
Discounted Cash Flow	For most businesses, where debt restructuring or sales are likely	Estimate future cash flows from the firms and discount them at an appropriate rate to estimate the present value of firms
Derived Investment Value	For loan portfolios	Estimate cash flows from collateral, with minimal concern for repayments

AMC = asset management company.
Source: Barents Group.

the AMC to break even at least on the recovery of the assets. This usually means setting transfer values lower than what selling banks would normally consider fair value. Such concerns can be reduced by the transfer of an AMC's equity shares to the troubled bank's shareholders. The value of assets transferred should reflect realistic current market prices so that the AMC is not motivated to delay the resolution of problems for fear of incurring losses. Furthermore, the values should ensure that the AMC does not suffer losses so that public confidence in the government's management of the situation remains high.

The following two examples highlight the different methods used by countries. In Mexico, the government generally paid a price for the NPAs that was at the high end of the valuation spectrum, as determined by special audits. To provide incentives for asset recovery, the AMC implemented a loan-loss program in which the selling, and in this case the servicing, banks had a limited share of the additional losses derived from the sale of the assets. In Malaysia, the AMC valued each NPA itself, on the basis of the net tangible asset and discounted cash flow methods. Instead of providing loan-loss provisions, the Malaysian AMC offered to share with the selling bank up to 80 percent of any profits earned from asset recoveries. As both countries' AMCs have only begun to dispose of their assets in a meaningful way, it is still too early to assess the effectiveness of each model.

ASSET MANAGEMENT AND RECOVERY

Provide for Interim Asset Management

Most asset management experts agree that it is very important that assets, especially past-due loans, be proactively managed to minimize losses. However, often there is a long delay between the time a decision to transfer assets to an AMC is made and the final transfer is completed. Then, once the transfer is accomplished, developing asset management and recovery plans (AMRPs) can take a significant

amount of time and due-diligence analysis. These time delays can result in a major loss in potential recoveries. Provisions should be made early for interim asset management while such plans are being developed.

Develop and Implement Asset Management and Recovery Plans and Principles

Performance-based AMRPs should be developed for each major asset or group of assets. The AMRPs should detail proposed recovery strategies and include cash-flow projections and an operating budget. The AMC should develop a senior-level process for approving AMRPs and any material modifications in them. Programs for monitoring compliance with AMRPs should be developed.

Some basic principles are suggested to guide the development of AMRPs. First, preference should be given to cash transactions over other forms of payments. The value of equity interests or other non-cash recoveries is arbitrary and subject to change. For similar reasons, it is also suggested that seller financing be underwritten prudently and used sparingly. When developing AMRPs, it is also important to measure funding costs and understand how different internal rates of return (IRR) can affect a recovery strategy. An AMC is likely to have the lowest cost of capital or IRR, foreign investors are likely to have the highest IRR, while the original debtors are likely to have an IRR falling somewhere in between. The impact of these IRR differences has at times led to disappointing results.

One example where IRR differences have occurred is in equity participation transactions with international investors. Typically, these agreements permit a foreign investor to purchase assets at attractive prices, with the AMC sharing in any recovery upside. However, a capital market investor has a cost-of-capital incentive to accelerate cash flows that may not always be in the best interest of the AMC. Sales strategies should not preclude such transactions, particularly to the extent that they bring in nec-

essary capital or expertise. However, it is important that the AMC fully understand the costs involved when engaging in such transactions. The experience of some countries, such as Thailand, has shown that investors in such transactions primarily engage in debt collection and negotiations. An alternative approach that should be considered would be to retain qualified asset managers or loan servicers on a contractual basis.

With regard to AMRPs, some specific recommendations include using bulk sales to dispose of large volumes of small-balance assets, including smaller packages for local investors and larger lots for institutional investors. One of the main criticisms of Thailand's asset sale strategy was that the AMC, acting on the advice of an investment bank, packaged lots too large for the domestic investor. As a result, the AMC sold many asset portfolios to a captive market of large foreign investment banks. Also, to the extent practicable, assets with homogeneous types of collateral or ownership, or assets with similar size debts, should be packaged together.

Support Decisions with Cost-Benefit Analysis

With regard to decisions to spend funds to enhance asset value, guidelines should be established requiring a rigid cost-benefit analysis. The same analysis should be used in making decisions about holding assets for better pricing. Such cost-benefit analysis should include a determination of the potential upside, including an assessment of the desired upside and the likelihood of asset realization, the potential downside, and any holding costs, such as interest and servicing or maintenance. The analysis should consider and document the potential for increased loss exposure, interference with market inefficiencies, moral hazard, and selectivity concerns. Holding costs, including funding and expenditure for maintenance, taxes, and both direct and indirect management costs, should be carefully evaluated. The AMC's relative expertise in maximizing collections should also be considered.

Resolving nonperforming business loans can be especially challenging because of employment issues and valuation difficulties. An AMC will likely be under intense pressure to help finance businesses or factories experiencing operational or financial problems. Also, assisting some companies and not others will undoubtedly raise fairness issues. Nonperforming loans require a consistent and transparent decision-making approach that is supported by careful evaluation. For this purpose, policies regarding the funding of business operations that consider expected costs and risks as well as potential rewards must be established. Such loans should be assigned to asset managers with business recovery expertise who can review business and financial operations and objectively develop the best business strategy. Decisions to rehabilitate a business should be supported with sales goals, financial targets, and cash-flow projections, as well as procedures for monitoring and enforcing compliance.

Conclusion

Transferring NPAs from operating banks to AMCs can play a vital role in rehabilitating the financial sector and the economy it serves. However, as indicated in this study, there are many operational and valuation issues to address. At the time of this study, most East Asian AMCs were still early in the process and strategies were still evolving. Designing and implementing an NPA resolution strategy can be a difficult challenge. Perhaps the most important considerations, though, are to realistically assess the magnitude of the problem and to act decisively and quickly. The longer systemic NPA problems go unresolved, the greater they will grow and the worse their impact will be on the economy.

It is also important to understand that while AMC strategies may resolve NPA problems, curing bad-loan symptoms does not necessarily remedy the underlying ills in the financial system. As stated early on and throughout this study, many factors can contribute to excessive NPA growth. Such factors

include too easy access to funds, undeveloped capital market alternatives to bank credit, lack of industry independence or experience or both, an inadequate supervisory structure, insufficient appraisal, weak accounting and disclosure rules, and a creditor-unfriendly legal environment.

Measures to resolve NPA problems would be woefully incomplete without a careful and objective analysis of their causes, followed by the implementation of a comprehensive action plan to correct any deficiencies. Failure to do so only increases the risk of repeatedly facing system-wide NPA problems.

Appendix 1

Asset Management Companies
of Selected Asian Countries

INDONESIA

Asset Management Unit

Structural design*Creation*

- In addition to the task of overseeing the bank rehabilitation process, the disposal of bad assets was centralized in the Indonesian Bank Restructuring Agency's (IBRA's) asset management unit (AMU) department. AMU's original mandate was to handle the nonperforming assets (NPAs) of the 54 troubled banks that were under the direct control or supervision of IBRA. In March 1999, the government indicated that it was in the process of transferring all the NPAs of state-owned banks and the recently closed 38 banks to AMU.

Goals and objectives

- AMU's objective is to maximize recovery and jumpstart investor interest. It plans to build a warehouse of assets, managing the workout loan portfolio to retain value.

Time frame

- At first, IBRA was responsible for supervising the banks under its control, but this responsibility has since been transferred to Bank Indonesia. IBRA was expected to complete its rehabilitation of the local commercial banks under its supervision by the end of 1998. On 6 November 1998, the government agreed to extend IBRA's life by four years. AMU officials do not believe that they have a specific time frame, but estimated that their work would be done within three to seven years.

Governance/Authority

- AMU is supervised by the Finance Minister. It is headed by a chairman appointed by the Presi-

dent, and four vice chairmen appointed by the Ministry of Finance. AMU is therefore not independent, but (as a subsidiary of IBRA) reports directly to the Minister of Finance.

Special powers

- The Director General of Financial Institutions at the Ministry of Finance indicated that the government deliberately provided IBRA with the authority to prevent the agency's decisions from being challenged in court. "There has to be special power because we are in a crisis and we have to move fast," he said. IBRA has basically been given *carte blanche* in its efforts to rehabilitate banks under its supervision even when its actions will contravene existing laws. AMU can foreclose on a loan without going to the courts, even if the debtor is seeking protection from the bankruptcy court. Because the legal environment does not permit the buying and selling of loans without debtor approval, special power was provided to IBRA to buy loans. However, the right to sell the loans was inadvertently omitted, although government officials have indicated that this omission will be corrected.

Funding

- The acquired NPAs will be replaced by government-guaranteed bonds, which will have a minimum holding period. In return, the state will get equity in the banks. AMU plans to fund its operating expenses from asset recoveries.

Transparency

- AMU maintains that transparency is crucial for its organization, although a Ministry of Finance official said that transparency in decision making is difficult because of the many nontechnical dimensions of the NPA problem. Officials state that there are guidelines for assisting companies, but these policies are not known to the public.

Operations

Organization

- AMU is organized into two major divisions: Asset Management Credit (AMC) and Asset Management Investment (AMI). AMC division manages and disposes of financial assets. In those cases where AMU has acquired an equity ownership from shareholders, AMI will perform due diligence on the company and determine whether or not to invest capital, restructure, merge, or liquidate the firm. A team is assigned to each obligator.

Asset valuation and acquisition

- All banks supervised by IBRA must sell to AMU for Rp1 their category 5 loans, which the government estimates to be 80 percent of all loans. Although a bank may sell its category 3 and 4 assets to IBRA if both parties can agree to a price, no such transaction is believed to have occurred. AMU uses discounted cash flow analysis to value the assets.
- As of February 1999, AMU had acquired Rp430 trillion worth of assets from the banks under its supervision. This figure includes about Rp230 trillion in mostly category 5 loans and about Rp200 trillion worth of corporate assets obtained from bank owners in settlement of their obligation to repay liquidity support from the central bank.
- As part of the 13 March 1999 banking reform measures, all NPAs of both state-owned banks and the 38 closed banks will be transferred to AMU. NPAs will be sold to AMU at net book value.

Asset management and recovery

- Assets transferred to AMU are classified into four categories: retail assets, consumer assets, physical assets, and corporate loans. AMU plans either to sell the retail and consumer loans in the first nine months or to subcontract them out to a bank for servicing. In all, it plans to contract out 80 percent of the loan accounts, or about 20 per-

cent of the total loan value. AMU has about 160,000 separate loan accounts, totaling Rp230 trillion. Most of these loans are classified as category 5. About 75 percent of these loans are to large corporate accounts, mostly to property-related businesses. Most corporate loans will be managed directly by AMU. There will be no performance hurdles. Borrowers who want to repay but cannot afford to do so because of the crisis will be helped with working capital and trade finance until their business recovers and they can service their loans again. In most cases, AMU will use an auction process that is focused on likely investors but open to all. It also plans to utilize profit-sharing schemes.

- *Creating value.* In dealing with the companies surrendered by debtors, the government plans to create value by restructuring and merging companies. The goal is consolidation within industries. If strategic investors cannot be found for the eventual privatization, the companies will be sold through initial public offerings in the capital market. AMU believes that the companies should be able to raise funds on their own, but it is willing to offer loan guarantees. All companies are required to submit business plans.
- *Asset recovery.* All in all, AMU has sold Rp1.6 trillion worth of assets, through 26 auctions of bank-owned vehicles and other properties, raising some Rp200 billion. According to its chairman, IBRA planned to recover 27 percent of the assets under its control by end-1999. AMU was to go on a roadshow to market the assets in February. According to the government's budget, recovery from asset sales is expected to bring Rp17 trillion for the 1999/2000 fiscal year starting April 1.

Management information systems

- AMU currently uses one of the banks' systems, UNISYS, to service the loans. It does not have an inventory system or a collateral valuation system.

Human resources

- Over 90 percent of AMU's asset management team of 170 personnel are from the private sector, including bankers, loan administrators, and industry specialists. IBRA has indicated that it will recruit, on a contract basis, over half of the 17,000 bank employees laid off in the 13 March 1999 round of bank closures to provide logistical support in the transfers of assets and liabilities.

Bank-Based Asset Management Companies

- In September 1998, the government stated that non-IBRA banks could either form their own asset management companies or ask IBRA for help. A Ministry of Finance official indicated that the government is leaning toward a more decentralized approach in managing the system's NPAs.

KOREA

In resolving nonperforming loan problems, the Korean government is relying primarily on a centralized government-based AMC model. In 1997, the government assigned the role of purchasing bad loans to the Korea Asset Management Corporation (KAMCO). More recently, the government authorized the creation of bank-based AMCs to facilitate the sale of two major banks, but the AMCs have not been established.

Korea Asset Management Corporation**Structural design***Creation*

- KAMCO is the government entity responsible for purchasing nonperforming assets to support the restoration of the financial sector. KAMCO was originally established in 1962 by Korean law to manage the foreclosure and sale of assets attached for tax arrears, the liquidation of corporations reverted to the treasury, and the handling and disposition of government-owned properties.

KAMCO also foreclosed and disposed of financial institutions' nonperforming assets on a fee basis. In 1997, through a special NPA Fund, KAMCO's role was expanded to include the purchase of nonperforming assets¹ to assist in the rehabilitation of the financial sector. KAMCO's expanded mission was to assist in the restoration of the financial sector's soundness and the recovery of the Korean economy. KAMCO became a public-sector "bad bank," and a nonperforming assets fund was created to finance the purchase of nonperforming assets. The government of Korea, the Korea Development Bank, and 24 banks are shareholders of KAMCO.

Goals and objectives

- The objective of KAMCO is "to expedite efficient disposal of NPAs for the betterment of liquidity and soundness of financial institutions, thus contributing to the development of financial industry and national economy."

Time frame

- Although KAMCO does not have a legislative limit, it plans to sell its entire portfolio by 2003.

Governance/Authority

- On 1 April 1998, KAMCO was placed under the supervision of the Financial Supervisory Commission's (FSC's) Financial Supervisory Services and removed from the supervision of the Ministry of Finance and Economy (MOFE). KAMCO is managed by a nine-member board of directors (consisting of its president, deputy president, auditor, and six directors), a 12-member

¹Nonperforming loans to be acquired by KAMCO are defined as follows: substandard—loans that have been in default for three months or longer; doubtful—loans with expected losses of an undeterminable amount; and assumed loss—loans with expected losses of determinable amount.

management supervisory committee (consisting of KAMCO's president and one member each from MOFE, FSC, the Korea Deposit Insurance Corporation [KDIC], the Korea Development Bank, the Korea Federation of Banks, the Korea Institute of Finance [current, not permanent, member], Cheil Bank, Hanvit Bank, and Kyoungnam Bank, a lawyer, and an accountant [current, not permanent, member]), and an executive director. KAMCO officials believe that they are able to operate with a good degree of operational independence.

Special powers

- Currently, KAMCO has no special authority, although pending legislation would permit it to appoint a special administrator to manage a borrower's business or assets or both.

Funding

- About 90 percent of KAMCO's funding comes from issued bonds. KAMCO bonds have a maturity date of three years from issue. They pay quarterly interest in arrears at a coupon rate applicable to three-year Korea Development Bank industrial finance bonds. The remaining 10 percent of KAMCO's funding comes from the central bank, financial institutions, and the Korea Development Bank.

Foreign-denominated bonds

- In May 1998, KAMCO planned to offer DM1 billion worth of bonds with five-year maturity. In December 1998, it issued dollar-denominated domestic NPA bonds worth US\$512 million to pay for foreign-currency-denominated NPAs purchased from 19 commercial banks.

Operations

Organization

- In 1998, KAMCO reorganized along new functional lines. It now has 13 departments: planning,

general affairs, computer, audit and inspection, fund management, corporation management, asset management (three divisions), overdue loan management, property disposition, tax disposition, and national property management. The functional organization structure seems appropriate, although further grouping of activities should be considered to improve management effectiveness.

Asset valuation and acquisition

- As of June 1999, KAMCO had purchased W46 trillion worth of NPAs² for W19.9 trillion from domestic financial institutions.³ By year-end 1999, it expected to purchase another W20 trillion in bad loans, including the failed assets from Korea First Bank. About one third of KAMCO's loans are to chaebol and other large corporations. Previously, KAMCO had paid for the assets with 30 percent cash and 70 percent bonds. In February 1998, KAMCO started paying for the NPAs entirely with KAMCO bonds.
- In the past, KAMCO had purchased NPAs from financial institutions in batches at fixed amounts up-front, based on the expected recovery value of the portfolio. KAMCO had then engaged in a due-diligence process on each NPA, adjusted the initial purchase price, and resettled depending on the nature of each loan and asset. In September 1998, however, KAMCO changed its acquisition method to a fixed purchase rate.⁴ The purchase rate calculation is indicated in Table A1.1.

²W44 trillion purchased through December 1998, broken down as follows: W35.3 trillion from commercial banks, W2.7 trillion from merchant banks, W5.9 trillion from guarantee insurance; W0.1 trillion from securities, and an insignificant amount from insurance companies. About 50 percent of NPAs are factories.

³KAMCO has recently been authorized to purchase foreign-currency-denominated nonperforming loans.

⁴KAMCO purchases are exempt from acquisition and registration fees, but this exemption does not carry forward for subsequent purchasers of the assets from the investor.

Table A1.1: Purchase Rate of Nonperforming Assets

Type	Purchase Rate
Ordinary NPAs^a	
Secured NPAs	Appraised value of collateral ^b — senior lien amount x 45 percent
Unsecured NPAs	Principal loan amount x 3 percent
Special NPAs^c	
Secured NPAs	Loan amount x 45 percent (for initial purchase ^d)
Unsecured NPAs	Principal loan amount x 3 percent

NPA = nonperforming asset.

^a Ordinary NPAs are loans that are currently in default, making no payments.

^b The appraised value of collateral is the value resulting from the latest appraisal by an independent appraisal agency at the request of the courts. KAMCO officials indicated that real estate assets are appraised by the Korea Board of Appraisers. Factory assets are broken down into three main categories: viable entities with good prospects, marginal but potentially profitable and salable entities, and nonviable entities ready for immediate liquidation.

^c Special NPAs have obtained court approval for restructuring as a result of corporate reorganization plans or composition proceedings.

^d As the court approves the restructured payment terms, the initial purchase price will be adjusted at: present value of projected cash flows x discount rate (base rate + credit risk + maturity risk).

Source: KAMCO.

Asset management and recovery

- *Recovery.* In January 1999, KAMCO indicated that it planned to dispose of W67 trillion of bad debt by the end of 2003. It intends to sell W16.14 trillion in 1999, W16.9 trillion in 2000, W13.97 trillion in 2001, W10.97 trillion in 2002, and W9.03 trillion in 2003. Of the total NPAs, W41.88 trillion will be recovered through an asset-backed securitization scheme or outright sale, W23.85 trillion in auctions, and the remainder through a workout scheme. The number of sales has thus far been limited because KAMCO does not have title to a large number of assets. As of July 1999, KAMCO had recovered W5.8 trillion through asset-backed securities, public auctions, and voluntary debt repayments.
- In a December 1998 auction, Texas-based Lone Star Fund purchased real-estate-backed NPAs worth W564.6 billion for W201.2 billion⁵ (a 64 percent discount) from KAMCO against competition from Goldman and Bankers Trust. KAMCO had acquired the debts collateralized by 1,500 houses, buildings, and factories from

financial institutions for W203.8 billion. This was KAMCO's first sale of assets using an international securitization vehicle under Korea's asset-backed securities law. As of August 1999, KAMCO had held four global auctions. It plans to hold one auction and issue one asset-backed security per month.

- *Recovery strategies.* KAMCO states that it will hold any asset that has the potential for high returns with value-added workout programs. It will sell as quickly as possible any asset with low value or with high costs. KAMCO will consider several alternatives for recovery: debt restructuring, outright sales, asset-backed securities and equity partnerships, foreclosure auction, and asset restructuring. KAMCO officials stated that they might offer seller financing and representations and warranties to accelerate sales. KAMCO does not have any method of prequalifying potential investors.
- *Joint ventures.* KAMCO plans to establish joint ventures with seven foreign investors to dispose of distressed assets. Each joint venture would have about W300 billion in assets, and 65 percent foreign ownership.
- *Debt restructuring.* KAMCO may choose to allow partial debt forgiveness, amended loan terms, or debt-equity swaps.
- *Outright sales and profit-sharing agreements.* In outright sales, loans are sold individually or packaged in portfolios and offered to investors. KAMCO transfers to the buyer all rights and title to the loan. After the transfer, KAMCO no longer has any interest or legal rights to the asset or proceeds from the collection of the loan. However, KAMCO has entered into profit-sharing agreements, where the purchasing firm agrees, after recovering its internal rate of return, to share with KAMCO any surplus profits realized from the servicing or sale of the assets.
- *Asset-backed securities and equity partnerships.* KAMCO assets are transferred into a

⁵This figure has also been reported at W141 billion.

special-vehicle trust, which in turn issues debentures and bonds to be sold to institutional investors. Part of the proceeds from the sale of the debt will fund various reserve accounts required by the trust, and the remainder will go to KAMCO. The debt is repaid with cash flow generated from the assets in the trust, through either the sale of individual assets or collection from property-level cash flow. Once the debt is retired, the equity participants of the trust are entitled to its future cash flow until all of the assets are sold off. Should KAMCO become an equity partner in the trust, it will benefit from an appreciation in value of the distressed asset. Its officials indicated that one difficulty with this scheme is obtaining a reputable rating agency to rate the securities. KAMCO would like to remain the asset manager, but appears willing to allow the private-sector investor to select the asset manager. Its officials stated that in the future they may experiment with a more modest-sized asset-backed security structure based on less sophisticated investment grading by local rating firms and local or international investment banking firms.

- *Foreclosure auctions.* KAMCO may dispose of assets through court auction. When secured loans are subject to court-approved foreclosure, KAMCO bids at the sale to protect its investment. Should no higher bid be received, KAMCO takes title to the property and disposes of it through public auction. In January 1999, KAMCO announced a variety of incentives to expedite the auction process: (i) market prices will be applied to determine the basic prices of assets (which used to be based on appraisal prices); (ii) all acquisition and registration taxes will be waived; and (iii) successful bidders will be able to use the property after paying 30 percent of the price, and will be able to exercise owner's rights after paying 50 percent of the price.

- *Asset restructuring.* As stated in its corporate principles, "KAMCO will serve as a value-added service entity for the NPAs. It will determine the viability and marketability of these assets, then utilize its own capital and resources to manage and further upgrade the marketability of the assets."⁶ KAMCO has about 30,000 borrower relationships. The vast majority of the NPAs are small-balance loans that require costly infrastructure to properly administer, manage, and recover. About 1,500 borrower relationships of KAMCO represent about 90 percent of the total value of its portfolio. For these assets, the Small and Medium Industry Promotion Corporation will make an individual assessment of each asset's technical feasibility and a consulting firm will perform a business feasibility study and develop an asset management and disposition plan, which will (i) address the collateral securing the loan, (ii) analyze the ability of the borrower to repay the obligation, (iii) recommend an exit strategy, and (iv) establish a minimum acceptable price. All assets associated with an operating business will be reviewed individually. Consideration will be given to reducing debt and taking equity or warrants in the business to improve its financial condition, if this alternative will assure the renewed profitability of the business.

Management information systems

- KAMCO is working with a management consulting firm to design and implement inventory, servicing, and loan accounting systems. The inventory system was expected to be operational by April 1999, but the servicing and loan accounting systems will probably not be operational for another six months.

⁶As of February 1999, KAMCO did not appear to have the legislative authority to make capital or working-capital advances to firms. It is therefore unclear how long it would take to obtain the necessary funding approval to proceed with this strategy.

Human resources

- KAMCO believes that it has reached its peak in staffing at about 1,300 employees with no further growth expected in 1999. About half of the employees came from various commercial banks.

Transparency

- KAMCO planned to publish its first audited accounts on 30 April 1999. It makes available due-diligence material for all potential bidders.

MALAYSIA**Pengurusan Danaharta****Structural design***Creation*

- On 21 May 1998, the government announced the creation of a national asset management company, Pengurusan Danaharta Bhd. (Danaharta), designed to manage and liquidate the financial system's NPAs. Danaharta was incorporated under the Companies Act of 1965 on 20 June 1998 and is wholly owned by the Ministry of Finance. Danaharta is not restricted to work with NPAs, but may also acquire performing loans.

Goals and objectives

- Danaharta's primary mission is to remove the bad assets from the system so that the banks can focus on making new profitable loans. Included in its mission is maximizing the recovery value of acquired assets. "Danaharta is neither a rapid disposition agency, nor a warehouse agency," said Azman Yahaya, Danaharta's CEO. "Danaharta will apply specific expertise in asset management and financial restructuring in order to maximize the recovery value of the acquired assets."

Time frame

- Azman indicated that he expects Danaharta to be operational for seven to ten years. He added that the life cycle of Danaharta would ultimately

depend on its asset-specific resolution and work-out plan. "Danaharta may grow to become a large conglomerate or it may decide to liquidate its assets and cease operations when it feels its job is done. The final decision will be based on maximizing value for the Government," he said.

Governance/Authority

- Depending on the value of a transaction, decision-making authority is delegated to the board of directors, executive committee, or management.
- *Board of directors.* The board of directors is the focal point of Danaharta's governance structure. It supervises all activities, approves all policies, and maintains control through executive and nonexecutive committees. The board has nine members: a nonexecutive chairman, the managing director, two nonexecutive directors from the government sector, three nonexecutive directors from the Malaysian community, and two nonexecutive directors from the international community.
- *Oversight committee.* An integral part of Danaharta's activities involves special administrators taking over the control of a business. The oversight committee approves appointments of any special administrators and independent advisers, any extensions of moratorium periods, and the termination of the services of special administrators. Officials from the Securities Commission indicated that the oversight committee does not closely monitor the performance of the special administrators. The committee, appointed by the Minister of Finance, comprises three members, one each from the Ministry of Finance, the Securities Commission, and Bank Negara. Their appointments are for two years.

Special powers

- Through the Danaharta Act and the National Land Code (Amendment) Act, Danaharta has

been given special legal powers. Under certain circumstances, Danaharta can override Section 176 of the Companies Act, which provides debtors some temporary protection from creditors.⁷ Danaharta's powers enable it to restructure a loan in two to three months, compared with 12 to 14 months under Section 176.

- *Statutory vesting.* Danaharta is allowed to step into the shoes of the selling institution, with the same rights and priority standing as a creditor. It takes clear title to the NPAs. The ownership of the security or collateral does not change hands. The borrower is still the owner of the loan collateral, but instead of dealing with the bank, the borrower deals with Danaharta.⁸ Although existing registered interests cannot prevent the transfer of the security, their approval is required before Danaharta can foreclose on the collateral. Therefore, Danaharta must deal with the existing registered interests before it can foreclose on a property. It may choose to sell the NPA through statutory vesting. This permits Danaharta to pass on the same interest it has in the NPA to the buyer. Danaharta can foreclose on an asset without the borrower's consent, with 30 days' notice.
- *Special administrators and independent advisers.* When a debtor company defaults on its obligations, Danaharta may appoint a special administrator (SA) to take over the company's management and control.⁹ Once the oversight committee approves the appointment, a 12-month moratorium from claims takes place, during which time no action may be taken against the

corporate borrower. Within these 12 months, the SA is required to prepare a workout proposal. Any recommendations for new capital must include funding sources from strategic investors or banks. The proposal is then given to an independent adviser (IA) who is approved by the oversight committee. The IA's role is to review the reasonableness of the proposal, taking into consideration the interests of all creditors. The proposal, together with the IA's report, is then given to Danaharta for final approval. If Danaharta approves the proposal, it goes to the secured creditors for consideration. A majority (in value) of secured creditors must approve the proposal before it can be implemented. Once it is approved, the relevant regulatory approvals must be obtained. There is no established mechanism for the creditors to register their complaints regarding the SA's performance. Only the oversight committee can replace an SA.

Funding

- The government recently reduced its estimates of Danaharta's operating expenses, originally estimated at RM25 billion, to RM15 billion.¹⁰ The government plans to fund RM10 billion of this cost through its Bond Issuance Program, a four-series issuance of five-year nominal-value government-guaranteed zero-coupon bonds. The first issuance, RM1.02 billion, was on 20 November 1998 and the second, RM1.6 billion, was on 31 December 1998. The bonds are tradable and carry a zero risk weight for capital adequacy purposes. Danaharta received RM500 million in seed capital from the government and expected to receive another RM1 billion by March 1999. It has obtained RM3.5 billion worth of loans from the Employees Provident Fund and Khazanah Nasional. Through their leveraging effect,

⁷Currently, debtors must obtain the consent of at least 50 percent of their creditors before filing an application for protection under Section 176.

⁸If a second charge was registered over the land by another bank, the second charge would continue to exist without any change in priority. Likewise, any caveats lodged over the land would remain. This means that although statutory vesting allows Danaharta to buy the NPA, it must deal with existing registered interests should it wish to sell the land.

⁹Danaharta sets the eligibility criteria for SAs.

¹⁰In March 1999, Azman indicated that Danaharta may require more than the RM15 billion earmarked for the agency.

Danaharta's powers enable it to resolve NPAs of other banks, which are also creditors to companies whose NPAs Danaharta has purchased, thus reducing its overall funding needs.

Transparency

- Current plan is for Danaharta to issue semiannual operating reports providing information on asset acquisitions and recoveries. Policies approved by the board of directors and the criteria for the selection of SAs are not made available to the public.

Operations

Asset valuation and acquisition

- Danaharta purchases NPAs having minimum gross values of at least RM5 million.¹¹ Any security associated with the loan is also transferred to the AMC. Danaharta pays "fair market value" for the loans. It values each NPA using net tangible asset and discounted cash flow methods. Loans can be acquired with or without recourse, and payment periods can be varied as needed. Danaharta conducts due diligence on the loan or asset or both to be acquired.
- *Loan selection.* Danaharta has indicated that only loans that have value or the potential for value are selected for acquisition. Small loans, such as consumer loans, credit card and vehicle loans, and even residential property loans, will be left out. Danaharta has indicated that it has no preferences when acquiring assets belonging to any particular sector or bank. It looks at all loans held by financial institutions in the country, although there is no obligation for any party to enter into an agreement with the AMC.¹²

¹¹Finance company NPLs under RM5 million are to be sold to a special-purpose vehicle.

¹²Banks that receive capital assistance from Danamodal must sell their NPAs to Danaharta. Danamodal is a special-purpose entity that was established to recapitalize the banking sector.

- *Incentives for institutions to sell to Danaharta.*

The government has provided several incentives to encourage banks to sell their NPAs to Danaharta. These include (i) setting a 10 percent ceiling on the amount of NPAs that a bank can hold, (ii) requiring banks to write down loans by 20 percent below Danaharta's offered price if rejected, (iii) allowing banks up to five years to amortize losses resulting from the sale to Danaharta, (iv) offering to share with the selling financial institution up to 80 percent of any profits earned from asset recoveries, and (v) giving Danaharta special powers to resolve NPAs that are not readily available to banks.

- *Assets under management.* As of September 1999, Danaharta had acquired a gross value of RM17.8 billion in bad loans from 39 financial institutions. In addition to the assets owned, it is also managing assets with a gross value of RM21.5 billion in NPAs on behalf of Bank Negara. All in all, it has taken over about 34 percent of the banking system's NPAs, which were purchased at an average discount of 40 percent.¹³ Danaharta has indicated that it has completed the bulk of its debt purchases. Offers made to acquire RM4.8 billion of NPAs were rejected by financial institutions.
- *Unsecured and offshore assets.* As of March 1999, Danaharta had not yet purchased unsecured loans. Over 70 percent of all NPAs above RM5 million are secured. Danaharta plans to discount these NPAs by 90 percent. In March 1999, it was given approval to extend its reach to acquire assets of domestic offshore banks in Labuan.

¹³As of April 1999, 28 percent of Danaharta's portfolio comprised NPAs to the property sector, purchased at an average discount of 28 percent, while 17 percent consisted of NPAs for the purchase of securities. Sixty-five percent of the NPAs were acquired from commercial banks, 22 percent from offshore banks, 5 percent each from finance companies and merchant banks, and 3 percent from development finance institutions.

Asset management and recovery

- Danaharta plans to hold real estate auctions every three months, with the first auction, consisting of 30 to 50 industrial, commercial, and residential properties, scheduled for November 1999. It may choose a number of strategies for the rehabilitation and sale of an asset:
 - Sell some or all of the loan to a third party,
 - Provide the borrower with enough time to refinance its obligations,
 - Provide additional financing to the borrower to enhance its viability,
 - Reschedule interest or principal payments or both to match projected cash flows,
 - Swap debt for equity, or
 - Pursue recovery through legal remedies.
- *Loan rescheduling.* For borrowers involved in “healthy” companies facing temporary cash-flow problems, Danaharta employs loan management strategies. Under this strategy, the loan repayment will be rescheduled and, where appropriate, the principal repayment will be deferred while turning short-term loans into long-term loans, or overdraft into term loans, to match the borrowing with the borrower’s business.
- *Value enhancement.* Danaharta has indicated that it is prepared to be proactive in restructuring poorly managed or undercapitalized businesses. Its officials have stated that their plans may include restructuring and merging companies in the same industry. The furniture industry was mentioned as one industry where the merger of several companies to create one dominant firm could enhance value. Danaharta plans to privatize restructured firms eventually. An SA is appointed to help restructure the company or industry in order to maximize recovery value. Danaharta will subcontract out the management of many of the business loans to private firms, although it will handle all real estate itself.
- *Subsidiaries.* The business NPAs will be restructured and consolidated under the various

Danaharta subsidiaries, including hotel and leisure, construction, infrastructure, general investment, industrial, and property. Some of these subsidiaries may eventually be listed on the stock exchange.

- *Property group.* Azman said that Danaharta would effectively emerge as the country’s largest property group. Danaharta will determine which assets to securitize, which ones to develop itself, and which ones to undertake with joint-venture partners. The securitization of property, to be carried out through real estate investment trusts, will specifically apply to high-yielding properties. Danaharta has also indicated that it may acquire property firms in its attempt to restructure the industry. Its officials said that the company planned to appoint a consultant to design a business plan for the hotel industry, of which it plans to control 30 percent. Vacant property will be held indefinitely.
- *Loan servicing.* In March 1999, Danaharta reached an agreement with Malayan Banking Bhd. (Maybank) for the latter to provide the operational facilities for all banking services to approved borrowers, including overdrafts, bank acceptances, and letters of credit. Danaharta had almost 1,000 (currently about 2,000) business loan accounts and expected at least 10 percent of these to use Maybank’s facilities. The average interest rate spread for such accounts would be about 2 percent above the bank’s base lending rate.
- *Liquidation.* For business loans that cannot be managed to add value, because the businesses have either ceased operations or been placed under receivers, Danaharta will liquidate the business and recover on the sale of the company’s assets. An SA will be appointed to expedite the process of selling the assets. Where a receiver has already been appointed, Danaharta may proceed with the same one. But if this fails, then an SA will be appointed.

- *Equity investment.* Equity participation from the private sector, Azman said, will not be through direct investments in Danaharta but rather through the assets acquired. For example, if Danaharta sets up a property subsidiary, it will invite equity participation in the subsidiary firm, but not in the AMC itself. Participation can also be achieved through securitization of assets, outright sales, or joint ventures.

Recovered assets

- In August 1999, Danaharta held its first restricted tender of foreign loans, receiving US\$52.5 million, consisting of US\$36.5 million in cash and US\$16 million in non-ringgit Malaysian loan assets. Successful bidders were US investment banks.

Management information systems

- Danaharta has developed inventory and valuation systems.

Human resources

- Danaharta now has about 150 employees, but is expected to add another 150 in the next two years. Although previously it needed support staff to draft legislation and to evaluate NPAs, it now requires workers with experience in managing businesses and property. Danaharta also contracts out to local and international advisers, consultants, accountants, and industry experts.

PHILIPPINES

Asset Privatization Trust

Structural design

Creation

- Through a presidential proclamation in 1986, the Asset Privatization Trust (APT) was created to take control of the failed assets of the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP). The role of this centralized government-owned entity was expanded

to include the control of state-owned assets identified for privatization.

Goals and objectives

- APT's mission is to "take title to and possession of the nonperforming assets identified for privatization, and to restore the existing physical facilities into viable and productive operations under private sector management and ownership." Its main objective is to generate "maximum cash recovery" for the government "within the shortest possible period."

Time frame

- Under Proclamation 50, APT was given five years to complete its mandate. But four subsequent laws extended its term to 31 December 1999. The "sunset provision" in APT charter provides that any remaining assets will be transferred to the office of the President.

Governance/Authority

- APT operations are overseen by a board of trustees, which in turn is supervised by the Committee on Privatization (COP), a cabinet-level body headed by the Secretary of Finance. APT has limited operational authority as all sales transactions must be approved by COP.¹⁴

Special powers

- APT officials have indicated that a lack of special powers and operational independence has impeded the pace and effectiveness of asset sales and recovery strategies.¹⁵

Funding

- Funding is provided by the Department of Finance.

¹⁴Formerly, only asset sales above P100 million had to be approved by COP.

¹⁵It takes an average of 170 days to obtain approval for a single asset liquidation.

Operations

Organization

- Under the board of trustees, there are nine departments: marketing, legal, financial and credit, management information systems, custodianship, accounting, internal audit services, personnel, and administration.

Asset valuation and acquisition

- In 1986, following an external audit to evaluate the assets and liabilities of PNB and DBP, the government transferred P108 billion worth of NPAs (17 percent of GDP) into APT.¹⁶ Of the 390 properties transferred, 98 had clear title and were ready to be sold. These assets included such properties as farmlands, hotels, nickel mines, cement firms, sugar and paper mills, and smelters.
- *State-owned assets.* In addition to privatizing the two banks' NPAs, APT also handled and continues to handle government assets transferred to its care for sale to the private sector. Initially, 103 government-owned or -controlled corporations were transferred to APT to be sold through public bidding. Currently, the list contains enterprises in a variety of sectors, ranging from finance to manufacturing to transport.

Asset management and recovery

- *Methods of sale.* In 1996, President Ramos issued Executive Order 298 authorizing APT to adopt alternative methods to privatize properties that were "very difficult to dispose of by final sale." Under this order, APT has concentrated on selling hard-to-sell assets by offering potential buyers the opportunity to acquire and develop government properties through joint ventures, lease purchases, management contracts, securitization, and build-operate-transfer schemes.¹⁷

¹⁶DBP makes up 64 percent and PNB 25 percent of APT's portfolio.

¹⁷To purchase a company, it is necessary for a foreign investor to form a joint venture with a Philippine partner holding a minimum of 10 percent interest.

- *Recovery.* The success of APT recovery is questionable. Out of its P147 billion worth of initial assets, it has so far recovered only P33 billion.
- *Sale criteria.* APT must obtain at least 90 percent of the appraised value to sell an asset. If the sale is unsuccessful after an asset has been offered for three months, the asset is reoffered for sale at a revised appraised value.¹⁸ This process is continued until the asset is sold. Sales are generally conducted through bidding.
- *Debt-equity swaps.* Although the government has stated that it is willing to entertain debt-equity swap proposals from foreign investors, the fees demanded by the government for processing such transactions are high—in the range of 5–10 percent. APT does not pursue partial forgiveness of debt in exchange for partial equity.

Management information systems

- APT maintains inventory and valuation systems.

Human resources

- Officials from APT indicated that it is often difficult to recruit good people because of the transitory nature of the entity. Selected staff from PNB and DBP participated in the loan workout task forces and were charged with managing the transfer of assets to APT. These tasks included preparing legal documentation preliminary to the sale or seizure of collateral, as well as preparing these assets for sale or recovery. For the NPA accounts that were to remain in the books of DBP and PNB, other task forces reinforced loan recovery.

Asset Resolution Corporation

- In November 1998, government officials outlined a proposal for a national Asset Resolution Corporation (ARC) to purchase, manage, and recover

¹⁸Assets are appraised by independent appraisers.

selected NPAs from banks and other financial institutions.¹⁹ ARC would purchase NPAs with preferred shares at a 30 percent discount, backed by government-guaranteed zero-coupon bonds. ARC would be a majority-owned private-sector asset management firm. The board of directors would consist of five members: one representative from the Department of Finance, the president of ARC, and three other private-sector individuals. Financial institutions and investors are studying the proposal. To date, no legislative action has been taken. The Department of Finance has reportedly asked three government banks to contribute up to 49 percent of the equity, with the remainder to be provided by the private sector. In theory, an approach that brings together limited government funding and passive ownership blended with private-sector ownership and expertise could offer substantial benefits.

Bank-Based Asset Management Companies

- The government has indicated that it may create a special-purpose vehicle to absorb the NPAs of the soon-to-be-privatized PNB.²⁰ In March 1999, the World Bank issued a report stating its disapproval of the government's proposal. It indicated that such an entity "does not appear to be warranted at this point" given the "more manageable scale of financial stress" in the Philippines.

THAILAND

Thailand has used both government-based (Property Loan Management Organization [PLMO], Financial Sector Restructuring Authority [FRA], Asset Management Corporation [AMC], and Radhanasin Bank) and bank-based asset management company strategies to resolve its financial crisis.

¹⁹ARC would also accept bad assets from other financial institutions such as pension funds, insurance firms, and the state-owned Home Development Mutual Fund.

²⁰The government hoped to divest its remaining stake in PNB before March 2000.

Property Loan Management Organization

- PLMO was formed in March 1997 to purchase distressed properties and rehabilitate them in order to relieve pressure on developers. It reportedly acquired three properties at a cost of B500 million. PLMO has since refused to account for the properties it acquired. In November 1998, the Bank of Thailand (BoT) prohibited the transfer of assets to PLMO.

Financial Sector Restructuring Authority

Structural design

Creation

- In October 1997, the government established FRA to evaluate the viability of finance companies' recapitalization plans and to manage the asset disposition of closed institutions. FRA has managed the liquidation of about B860 billion worth of bad assets taken over from 56 closed finance companies. Most of the assets are commercial real estate loans, backed by land and property as collateral. Officials had hoped to receive 40–60 percent of book value from the sale of assets.

Goals and objectives

- The main goal of FRA is to dispose rapidly of the assets transferred to its care, but not to manage assets for maximum recovery. It does not focus on servicing the loans and is prohibited from restructuring debt. On the basis of six-month arrears,²¹ about 90 percent of the assets held by FRA are nonperforming.²² Its objective is to create a market for distressed assets and to build up the economy's confidence level.

²¹Thailand is set to change the regulatory definition of an NPL from six to three months. Until recently, banks could roll over NPLs indefinitely.

²²Officials from the Bangkok Bank of Commerce indicated that the finance companies' NPAs, when transferred to FRA, were only about 20 percent, but had increased to the current level because FRA did not service the loans.

Time frame

- There is no specific time frame for dissolving FRA. The authority initially planned to sell all assets by the end of 1998, but now officials hope to dispose of all assets by year-end 2000.

Governance

- FRA's board is composed of a mix of government and private-sector members, including the Ministry of Finance (MOF) and BoT officials and investment bankers. Sales transactions are approved by the board.

Funding

- The acquisition of assets is funded through the Financial Institutions Development Fund (FIDF), which has become the largest creditor of the closed finance companies. The World Bank provided seed capital to form FRA.

Transparency

- The New Aspiration Party, an opposition political group, has criticized FRA for its lack of transparency. Boonchu Rojanastien, an adviser to the House Committee on Finance and Banking, in a detailed criticism of FRA and its activities, said that the agency had failed to deliver information on the financial status of the closed 56 finance firms, as well as its operating expenses, to the House Committee. Although the local press and government officials have been critical of FRA, questioning the sale of assets to foreigners at fire-sale prices, US officials have said that foreign businessmen and observers in Bangkok have given FRA high marks for planning and execution of the auction process, transparency, and service to bidders. FRA has indicated that all investors are allowed to review material on each asset in the data collection room. Potential investors may also talk to debtor businesses with the permission of FRA.

Operations

Organization

- FRA is governed by a board of directors and has several divisions: supervision, information systems, corporate affairs, treasury, compliance and legal, asset realization, research and information, and internal administration.

Asset recovery

- *Auctions in 1998.* FRA auctions of noncore assets began in February 1998. The “world’s biggest one-day auction” took place on 15 December 1998, with the proceeds from the sale of business loans earmarked for FIDF and other creditors. This auction was widely considered a failure. Out of a total of B388 billion in assets available, only B32 billion worth were sold—at a 63 percent discount. Revenues from the nine (out of 45 lots) winning bids amounted to 37 percent of the principal, or about B12 billion. Four bidders won the nine lots, with eight going to three Thai financial institutions, and the ninth, a telecommunications lot, going to Global Thai Finance and Securities, a Lehman Brothers subsidiary.
- On 17 December, FRA negotiated to sell six more lots. The highest bid offer was 38 percent of principal and the lowest, after negotiation, was 23 percent. Each asset portfolio had a separate benchmark price that was used by FRA to evaluate the bids. FRA had reserved the right not to sell any of the lots at a price lower than expected. As of December 1998, FRA had raised about B106 billion from asset sales, about 30 percent of book value.
- The poorer-than-expected results of the auctions have been blamed on a number of factors: the failure of Parliament to pass legal reforms, including proper bankruptcy laws;²³ the high number of loans in litigation; the poor quality of the

²³Previously, debtors were able to hold on to properties indefinitely.

assets; the large size of lots; prior commitments to IMF; time limitations for due-diligence reviews (six weeks); the prohibition against direct foreign ownership of land; and inaccurate valuation methods. FRA postponed the December auction, originally scheduled for 2 December, in order to rearrange the bids into 45 packages, rather than 32.

Payments before settlement date

- In the case of hire-purchase contracts, principal cash flows between the “accounting” date and the “settlement” date amounted to an average of 45 percent of the total amounts of the winning bids for all tranches. In the most extreme case, principal cash flow amounted to about 80 percent of the winning bid price.

Foreign investment

- FRA claimed that its main goal is not to attract foreign investors, although a Lehman Brothers official, one of FRA’s foreign advisers, indicated that attracting foreign investment was a primary objective. In July 1998, a sale of automobile loans raised B25 billion, about 48 percent of book value, with GE Capital buying 85 percent of portfolio. In August 1998, Lehman Brothers paid B11.5 billion, or 47 percent of registered value, for a tranche of 17,474 residential mortgages. After purchasing the portfolio, Lehman reportedly applied to SEC for permission to securitize the assets, issuing mortgage-backed securities for sale in the local markets.
- In the 15 December auction, Global Thai Finance and Securities/Lehman Brothers purchased a telecommunications lot valued at B3.25 billion for B1.2 billion, a 63 percent discount. About 47 percent of the portfolio was nonperforming. Four of the tranches of assets were sold via negotiations to Goldman Sachs and GE Capital, which paid B27.3 billion for loans with an outstanding balance of B123 billion. As of December 1998,

Goldman Sachs had acquired B110 billion of diversified assets, ranging from 20 to 23 percent of book value.

Profit sharing

- FRA has signed profit-sharing agreements, such as the one reached with Goldman Sachs in December 1998. Ninety percent of the bid price was to be paid in cash, and an amount equal to 20 percent of the bid price would be paid in transferable notes issued by a mutual fund established to manage the assets. Under this type of profit-sharing agreement, investors are allowed to purchase assets below established FRA benchmark prices, but must share future capital gains with the government. Bidders are prohibited by law from reselling the assets for at least six months. Another rule prohibits using an escrow account to transfer funds from debtors to bid winners within the six-month period. FIDF indicated opposition to these profit-sharing agreements.

Brokers

- The Goldman-led consortium was a broker for the original debtors of the 56 failed financial institutions. Goldman and GE Capital reportedly agreed to drop any contracts made before the auction with original debtors to avoid the appearance of collusion. According to FRA principles, debtors are allowed to negotiate with potential bidders before an auction, although it is illegal for a debtor to bid on a package of assets if he or she is the borrower for more than 10 percent of the assets. It is also illegal for relatives of the debtor and companies owned by the debtor to bid on the packages. However, a third party, which may include former executives of the failed finance companies, can make a deal with the debtor before any purchase, allowing the debtor partial relief on his or her debt repayment and bringing the third party a profit.

Bidding process

- FRA announced on 4 September 1998 that in the auction of corporate and commercial real estate loans, it would accept unsolicited bids for individual assets or groups of assets. Consideration was given to participants by requiring a reduced data room fee and a refundable deposit. Only bids of at least B5 billion were accepted before the 30 September deadline.²⁴ FRA used the unsolicited bids to package the assets into tranches that were announced on 15 November 1998 and all interested investors were able to bid on the tranches by 2 December 1998. This procedure was different from FRA auctions of hire-purchase (primarily auto) loans and residential mortgages, where the assets were packaged into tranches before the start of the auction.
- According to FRA, the procedure was changed because the portfolio of corporate and commercial real estate loans (which make up 60 percent of the closed companies' core assets) was much larger and more complicated than previously auctioned portfolios. Many loans in the corporate and commercial real estate loan portfolios were cross-collateralized by the same asset. FRA used the unsolicited bids to determine which pieces of underlying collateral generated the most investor interest, and then grouped loans together on the basis of that interest in an effort to maximize bids.
- *Bangkok bid.* FRA has introduced a new bidding system, called the "Bangkok bid," in which investors are allowed to bid for multiple lots, even if they do not have enough money to buy all the loans for which they offer bids. The new system encourages more bids, said FRA, helping it to gauge the competitiveness of bids.

²⁴Originally, there was a minimum bid requirement of B10 billion.

March 1999 FRA auction

- After several delays to attract more bidders, and to give Parliament more time to approve a new bankruptcy law, FRA planned an auction of B229 billion worth of business loans for 19 March 1999. To encourage greater participation by domestic investors, the 46 business loans, comprising 7,075 individual assets, were separated into 36 small tranches, with outstanding principal balances of B1.5 billion–B5 billion, and 10 large tranches, with outstanding principal balances of B13 billion–B15 billion. Loan collateral consisted primarily of real estate.
- *Cash-flow sharing.* Winning bidders for large tranches were permitted to pay 80 percent of the bid price to FRA up-front, and pay the remainder from cash flows they would receive from servicing the assets after deducting operating expenses, at a fixed percentage set by FRA. Once the winning bidder had achieved its internal rate of return, all net proceeds from servicing the assets would be shared, with 80 percent of the net proceeds going to the winning bidder and 20 percent going to FRA. One market analyst commented that the winning bidder could, theoretically, set up a nominee company soon after the bid and sell the asset to that company, sharing the nominal benefits with the FRA right away. The company could then manage those assets and keep all the upside.
- *Securities as payment.* On 18 February 1999, FRA indicated that investors could purchase Thai assets using Thai government bonds, state enterprise bonds guaranteed by MOF, or bonds issued by the state-owned Asset Management Corporation. Foreign bonds would also be allowed if their credit ratings were higher than Thailand's current sovereign rating.²⁵ Prices of the accepted securities had to be converted us-

²⁵Standard and Poor's rating for Thailand is BBB and Moody's is Ba1.

ing a standardized discount table provided by FRA.

- *Results.* At the 19 March 1999 auction, FRA sold B221.5 billion worth of assets, 44 out of the 46 asset lots, for B40.32 billion, an 82 percent discount (Table A1.2). The largest winner was AMC, which purchased 29 lots, including all 10 large lots, for B32 billion. In addition to a few local investors, Goldman Sachs won three lots for B1 billion, Lehman Brothers won one group for B470 million, and Starwood purchased one lot for B830 million.

Management information systems

- FRA has indicated that it cannot separate good from bad assets because it does not have the necessary systems.

Human resources

- FRA employs 270 people, many from the private sector.

Asset Management Corporation (for Finance Companies)

Structural design

Creation

- In October 1997, the government of Thailand, by royal decree, established a special-purpose, government controlled, centralized AMC, or “bad bank,” to bid on and manage FRA’s bad assets,

obtain assets from firms owned and managed by FIDE, and purchase assets from the Property Loan Management Organization.

Goals and objectives

- AMC’s goals are fourfold: to bid for NPAs at fair prices; to manage and dispose of assets by ensuring higher asset value, avoiding any operational losses and increasing the entity’s net worth; to act as the “bidder of last resort” for the assets left over from FRA’s auctions; and to ensure that faithful debtors are rescued with as much justice as possible. Its stated objective is not to maximize profits, but to revitalize the economy by rehabilitating enterprises. AMC officials have stated that they are more concerned with principles than mathematics.

Time frame

- There is no legislated time frame for AMC’s operations.

Governance/Authority

- AMC is wholly owned by MOF. Its seven-person board consists of the chairman, from MOF; one managing director; and five directors, from FIDE, the National Housing Authority, MOF, academe, and the private sector. MOF appointed all the members with the concurrence of the Cabinet.

Table A1.2: Total Recovery Results (approximate values)^a

Type of Asset	Book Value (B billion)	Auction Value (B billion)	Discount (Percent)
Hire-purchase (June 1998)	51.8	24.9	52
Residential mortgages (August 1998)	24.6	11.5	53
Business loans (December 1998)	155.7	39.0	75
Business loans (March 1999)	221.5	40.3	82
Construction loans (July 1999)	1.3	0.2	85
Commercial and other loans (August 1999)	129.0	31.0	76
Total core asset sales (as of August 1999)	583.9	146.9	75
Noncore assets	150.1	34.0	77
Total	734.0	180.9	75

^a The last auction of B30 billion was scheduled for November 1999. FRA plans to file bankruptcy lawsuits against the debtors for the remaining assets. Source: Financial Sector Restructuring Authority.

Special powers

- AMC is exempted from the payment of various fees (machinery registration, land registration, and vehicle transfer fees) and taxes (corporate income, value-added, specific business, and stamp duty taxes). It is also exempted from notifying its debtors of transfers of claims as required under the Civil and Commercial Code. In addition, it is entitled to stipulate and demand the highest interest rate from its debtors.

Funding

- With B15 billion in seed capital from the government, and the ability to issue domestic zero-coupon bonds worth up to 12 times its capitalization, AMC can raise up to B180 billion to purchase FRA assets. MOF has indicated that it will guarantee a portion of AMC's five- and seven-year bonds.²⁶ FRA will transfer AMC-issued debt to creditors of the 56 finance companies, with a 20–30 percent depreciation expected for creditors because of the time delay before the debt matures. AMC plans to raise the funds to pay the interest expense of about B15 billion per year by issuing promissory notes. AMC promissory notes would have maturities of about three to seven years to match the time it would take to manage the assets, and a yield of 8–9 percent.

Operations

Organization

- AMC is divided into 13 departments: asset investment, hire-purchase, consumer loan, commercial loan, real estate loan, asset appraisal, collateral and accounts receivable, legal, computer system, office of the president, general administration, accounting and finance, and internal audit.

Asset valuation and acquisition

- In valuing the assets, AMC will classify the loans as performing or nonperforming, and according to type of collateral and type of loan. AMC has announced that it has set up asset-value calculation guidelines based on the cash flow from loan repayments as well as cash flow from collateral. The ultimate bidding price requires the approval of AMC's board of directors. Before 19 March 1999, AMC had been prohibited to bid at auctions.
- Beginning 19 March, if FRA determined that a private-sector bid did not meet its internal benchmarks, AMC was given an opportunity to bid on the assets. AMC has a mandate to bid at a "fair" or "professionally valued" price, but is legally prohibited from bidding more. If a fair value cannot be agreed upon between FRA and AMC, MOF would help to negotiate a price.

Asset management and recovery

- AMC has purchased 29 billion lots, with a book value of B185 billion, for B32 billion (an 83 percent discount). Large lots were sold to AMC using the cash-flow sharing method. AMC paid for the assets with five-year promissory notes, discounted using a formula set up by FRA.
- After acquiring the assets from FRA, AMC will reclassify loans, negotiate with debtors over the repayment process, and foreclose against unwilling borrowers. Unlike FRA, AMC is able to renegotiate debt terms to ease the burden on the borrower. AMC may support needy debtors that still have business potential, by extending additional loans to help them continue their operations. AMC plans to serve as a mediator in the search for new partners for some debtors. It claims that it has been approached by several foreign financial institutions offering lines of credit. AMC may securitize part of the loans or resell some of them or both. It has stated that it will subcontract out assets only to a few private asset managers.

²⁶Even without a full ministry guarantee, however, Thai law stipulates that if the AMC registers losses, the government would have to set aside funds to cover them.

- AMC plans to dispose of the assets within three to seven years through private placement, bidding, securitization, and sales agent distribution. It may also offer limited warranties.

Management information systems

- AMC believes that it has appropriate inventory systems.

Human resources

- AMC has hired bankers and property experts, and subcontracted some legal, accounting, and clerical duties. It does not plan to hire FRA employees. It cannot offer incentives for managers to reach specified recovery goals.

Foreign advisers

- AMC has initially decided not to appoint a foreign adviser, but will use the financial pricing formulas devised by FRA.

Radhanasin Bank

Good bank

- In addition to AMC, the government created Radhanasin Bank (RAB), a “good bank” to manage salvageable bank assets. RAB was initially formed to bid only on the highest-quality assets at FRA auctions and leave the undesirable ones to AMC. It would pay in cash, debt instruments, or bank shares, with creditors to the closed finance companies having the option to become shareholders.

Commercial bank

- In January 1998, FRA stated that RAB would no longer function as a good bank, but would rather act as a commercial bank, with lending and deposit-taking capability. However, FRA added that it did not want RAB to compete with other commercial banks in terms of deposits. It would focus on asset acquisition, purchasing both good and bad assets.

RAB Asset Management Company

- In August 1998, the government merged RAB with Laem Thong Bank, which had a total of about B40 billion in NPAs. In March 1999, the government said that it would keep up to 49 percent of the privatized RAB. BoT indicated that it would set up a bank-based asset management company to buy the bad loans inherited from Laem Thong. The NPAs would be managed by the bank or its partner, if the buyers insisted on a separation of the assets. RAB/AMC would pay for the loans with long-term bonds backed by FIDF guarantees. RAB/AMC would not sustain losses greater than RAB’s provision for bad debts before the separation of assets. The bank and its shareholders must absorb at least 15 percent of any additional losses suffered by RAB/AMC, and FIDF would take 85 percent. This ratio can be adjusted depending on the state of the economy.²⁷

Bank-Based Asset Management Companies

- On 28 December 1998, in order to enable financial institutions, including commercial banks and securities companies, to reduce their levels of NPAs, BoT introduced criteria for the establishment of individual bank-based asset management companies (BBAMCs). Financial institutions, which would hold more than 50 percent of a BBAMC, would have to maintain a minimum capital adequacy ratio of 8.5 percent and would have to prepare consolidated financial statements.²⁸ BBAMC shares held by a financial

²⁷BoT will also assume 85 percent of any profits and losses incurred by the state-owned Radhanasin Siam City and Bangkok Metropolitan banks in the first five years of operation. The remaining 15 percent will be assumed by new strategic investors. After five years, assets that cannot be rehabilitated will be liquidated, with the proceeds returning to BoT. The government hopes that this 85/15 formula will serve as an incentive to work out bad debts within five years.

²⁸A financial institution must disclose details concerning its investment in BBAMC, including loans granted to the latter; an evaluation of BBAMC’s assets, income, and expenditures; any transaction between the financial institution and BBAMC; and separate financial statements (including a cash-flow statement) of BBAMC.

institution must include shares held by the nominee of the financial institution. Assets managed by BBAMC must be classified as substandard loans of the financial institution. A financial institution that sells NPAs to a BBAMC must do so at fair value, not to exceed book value. Extension of credit to a BBAMC by a financial institution must be done on normal terms and conditions. BBAMC can raise funds from bank loans, floating shares, or debt issues. Borrowing from BBAMC's parent financial institution is limited to 25 percent of its paid-up capital funds. After examining the transferred NPAs, BoT will allow a grace period before classifying BBAMC shares.

- BBAMC must submit a plan to BoT for each acquired asset, which must include the name of the financial institution, the type and value of the asset to be acquired, the date of the transaction, and the agreement or conditions governing the acquisition. BBAMC may recover the NPAs in a number of ways: providing new lending, collecting interest revenue and fees, securitizing assets, restructuring the debt, acquiring shares of the borrower's company, or converting debt to equity. Financial institutions are not required to pay asset transfer taxes if they sell the NPAs to their own BBAMC.
- The Bangkok Bank of Commerce (BBC) was the first bank to form a BBAMC. BBC transferred B7 billion worth of good assets to Krung Thai Bank, and then transformed itself into a

BBAMC, Bangkok Asset Management (BAM), to manage and dispose of its NPAs, estimated to be about B50 billion. To facilitate the management of NPAs, the Cabinet recently agreed in principle to exempt BAM from regulations governing state enterprises. BAM will have autonomy over employment and wage scales, including specific benefits to executives. The Thai Farmers Bank (TFB) is also scheduled to form a BBAMC. Foreign asset managers will be compensated on the basis of net recoveries. TFB plans to transfer one third of its NPAs to BBAMC at about 55 percent of book value. In September 1999, the government announced that Krung Thai Bank would transfer some of its NPAs to the central bank for management and disposition.

- Several Thai banks have publicly expressed dissatisfaction with the incentive structure for the establishment of BBAMCs, claiming that the appropriate legal, tax, and accounting infrastructure is still not in place.

Centralized Asset Management Company (for Commercial Banks)

- Because of budgetary constraints, MOF has indicated that the Thai government is unwilling to set up a centralized asset management corporation for banks as it has done for finance companies. The government is reportedly considering permitting AMC established for the finance companies to purchase the banks' NPAs.

Appendix 2

Background Information on Asset Management Companies

Table A2.1: Magnitude of Crisis, AMC Type and Approach^a

Country	Magnitude of Financial Sector Crisis	Type and Approach
Indonesia (1997 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> 70% of loans were nonperforming, representing about 50% of GDP in 1997 <p>Insolvent Banks^b</p> <ul style="list-style-type: none"> In 1997, government closed 16 small banks As of year-end 1998, government controlled/supervised 54 banks (institutions representing about one quarter of total banking assets) In March 1999, government closed 38 banks, recapitalized 9, and nationalized 7 (institutions representing about one fifth of total banking deposits)^c 	<p>Type</p> <ul style="list-style-type: none"> Indonesian Bank Restructuring Agency (IBRA) – restructuring agency <p>Approach</p> <ul style="list-style-type: none"> Centralized approach IBRA has two main functions: to supervise banks in need of restructuring and to manage the assets it acquires in the bank restructuring process through its Asset Management Unit (AMU)
Korea (1997 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> 35% of loans were nonperforming, representing about 35% of GDP in 1997 <p>Insolvent Banks^d</p> <ul style="list-style-type: none"> Closed 5 small banks, nationalized 2 large banks, and recapitalized 7 banks (institutions representing more than one quarter of total banking assets) 18 out of 30 merchant banks were insolvent (merchant banking assets represent about 5% of total banking assets) 	<p>Type</p> <ul style="list-style-type: none"> Korea Asset Management Corporation (KAMCO) – restructuring agency <p>Approach</p> <ul style="list-style-type: none"> Centralized approach; special purpose vehicle for management and disposition of banking system's NPAs
Malaysia (1998 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> 30% of loans were nonperforming, representing about 40% of GDP in 1997 <p>Insolvent Banks^e</p> <ul style="list-style-type: none"> RM6.2 billion injected into 10 financial institutions (institutions representing about one eighth of total banking assets) Government is supporting a merger program of commercial banks, finance companies, and merchant banks 	<p>Type</p> <ul style="list-style-type: none"> Danaharta – restructuring agency <p>Approach</p> <ul style="list-style-type: none"> Centralized approach; special-purpose vehicle for the management and disposition of banking system's NPAs
Thailand (1997 to present)	<p>Banking System (estimate at peak levels)</p> <ul style="list-style-type: none"> 50% of loans were nonperforming, representing about 70% of GDP in 1997 (NPLs for the largest domestic bank reported to be as high as 84%) <p>Insolvent Banks^f</p> <ul style="list-style-type: none"> Government suspended 58 finance companies (institutions representing about one eighth of total banking assets) Government intervened in 6 local commercial banks and signed memorandums of understanding (MOUs) with 4 others (institutions representing about one third of total banking assets) 	<p>Type</p> <ul style="list-style-type: none"> Financial Sector Restructuring Authority (FRA) – rapid disposition agency Asset Management Corporation (AMC) – restructuring agency Radhanasin Bank (RAB)^g – restructuring agency Bank-Based Asset Management Companies (BBAMCs) Central Bank Asset Management^h <p>Approach</p> <ul style="list-style-type: none"> FRA – centralized approach; two main functions: evaluate finance companies rehabilitation plans and sell their assets AMC – centralized approach; bidder of last resort for FRA's "bad" assets RAB – centralized approach; bidder on FRA's "good" assets BBAMCs – decentralized approach for commercial banks (private and state), including the transfer of Krung Thai Bank's NPAs to the central bank

^a The format of this table was designed by the World Bank.

^b As of mid-1997, the Indonesian banking system had 239 banks (about 96% of total assets) and 248 finance companies (about 4% of total assets).

^c The government plans to merge three state-owned banks, representing 30% of total bank deposits.

^d As of mid-1997, the Korean banking system had 26 commercial banks (about 50% of total assets), 7 specialized and development banks (about 20% of total assets), and thousands of nonbank financial institutions (about 30% of total assets).

^e As of mid-1997, the Malaysian banking system had 35 commercial banks (about 70% of total assets), 39 finance companies (about 20% of total assets), and 19 merchant banks and discount houses (about 10% of total assets).

^f As of mid-1997, the Thai banking system had 15 commercial banks (representing about 70% of total assets), 91 finance companies (about 20% of total assets), and rural credits (about 10% of total assets).

^g RAB was initially created to manage the failed finance companies' quality assets, leaving the bad assets to AMC. In January 1998, the government announced that the RAB would no longer serve in this capacity, but would rather act as a commercial bank.

^h In September 1999, the government announced that Krung Thai Bank would transfer some of its NPAs to the central bank for management and disposition.

Source: Barents Group interviews with government officials, World Bank, IMF, and financial press.

Table A2.2: Ownership and Management of AMCs

Country	Ownership and Legal Structure	Governance Structure ^a and Disclosure Requirements	Primary Objectives
Indonesia (1997 to present)	<p>Ownership</p> <ul style="list-style-type: none"> Ministry of Finance <p>Legal Structure</p> <ul style="list-style-type: none"> Established by presidential decree and revised banking law in 1998 	<p>Governance Structure</p> <ul style="list-style-type: none"> The Ministry of Finance supervises IBRA/AMU, assisted by two boards: the Financial Sector Advisory Committee, composed of senior cabinet level ministers, and the Independent Review Committee, composed of international banking sector professionals appointed by the IMF Managed by a chairman, who is appointed by the president, and four vice chairmen, who are appointed by the Ministry of Finance IBRA/AMU has not published operational “rules of ethics” to avoid potential conflicts of interest <p>Disclosure Requirements</p> <ul style="list-style-type: none"> IBRA/AMU indicates that it issues regular reports to the financial authorities, but none appears to have been made public Guidelines for assisting companies are not made known to the public Requirements for independent audits of financial statements for IBRA/AMU are unknown <p>Independence</p> <ul style="list-style-type: none"> IBRA/AMU does not enjoy operational independence as it operates as a subsidiary of the Ministry of Finance It is unclear whether the Independent Review Committee has any substantial authority 	<p>Maximize recoveries and enhance value</p> <ul style="list-style-type: none"> Build a warehouse of loans and manage workout loan portfolios to retain value Maximize proceeds through well-timed asset sales
Korea (1997 to present)	<p>Ownership</p> <ul style="list-style-type: none"> Shares owned by the Ministry of Finance, the Korea Development Bank, and 24 commercial banks <p>Legal Structure</p> <ul style="list-style-type: none"> Established by law in 1962 to manage and dispose of government-owned properties Role expanded in 1997 through the Nonperforming Asset Fund to purchase NPAs 	<p>Governance Structure</p> <ul style="list-style-type: none"> On 1 April 1998, KAMCO was removed from the Ministry of Finance’s supervision and placed under the Financial Supervisory Commission (FSC) Managed by a board of directors (consisting of the president, deputy president, auditor and six directors) and a Management Supervisory Committee (MSC) (currently consisting of the president, one member from the Ministry of Finance, FSC, Korea Deposit Insurance Corporation, Korea Development Bank, Korea Federation of Banks, Korea Institute of Finance, Cheil Bank, Hanvit and Kyoungnam Bank, plus one accountant and one lawyer) KAMCO has not published operational “rules of ethics” to avoid potential conflicts of interest <p>Disclosure Requirements</p> <ul style="list-style-type: none"> Publishes audited financial statements Due-diligence material available to potential bidders <p>Independence</p> <ul style="list-style-type: none"> The KAMCO board reportedly enjoys operational independence within the policies established by MSC, although the extent of involvement, if any, by MSC members in specific transactions is unknown 	<p>Maximize recoveries and enhance value^b</p> <ul style="list-style-type: none"> To assist in the rehabilitation of the economy by acquiring, managing, and disposing of NPAs Create value-added service entity for NPAs
Malaysia (1998 to present)	<p>Ownership</p> <ul style="list-style-type: none"> Ministry of Finance <p>Legal Structure</p> <ul style="list-style-type: none"> Incorporated under the Companies Act of 1965 on 20 June 1998 	<p>Governance Structure</p> <ul style="list-style-type: none"> The board of directors, comprising 9 members (2 from government and 7 from private sector) approves all policies and supervises all activities The Oversight Committee, comprising 3 members appointed by the Minister of Finance (1 from the Ministry of Finance, 1 from the central bank, and 1 from the Securities Commission), approves Special Administrators and Independent Advisers for distressed businesses Danaharta has not published operational “rules of ethics” to avoid potential conflicts of interest 	<p>Maximize recoveries and enhance value</p> <ul style="list-style-type: none"> Remove distressed assets so that banks can focus on making new profitable loans Maximize recovery value of assets through asset management and financial restructuring

Disclosure Requirements

- Issues semiannual operating reports
- Requirements for independent audits of financial statements for Danaharta are unknown
- Board policies and selection criteria for Special Administrators are not made public

Independence

- Given the balanced composition of the board, Danaharta reportedly enjoys independence in day-to-day operations^c
- Reportedly, decision-making authority is delegated to the board of directors, the Oversight Committee, or Danaharta management on the basis of transaction size
- Transactional authority levels are unknown

Thailand
(1997 to
present)

Ownership

- FRA and AMC: Ministry of Finance

Legal Structure

- Established by royal decree in 1997

Governance Structure

- FRA – A board of directors oversees operations and approves all sale transactions. The board consists of three individuals with private-sector experience appointed as directors by the Minister of Finance, one of whom serves as chairman, one representative from the Bank of Thailand and the Ministry of Finance, and the Secretary General of FRA.^d
- AMC – Board is chaired by an official from the Ministry of Finance and is composed of six additional members appointed by the Ministry of Finance: one managing director and five directors (three from government, one from academe, and one from the private sector)
- Neither FRA nor AMC has published operational “rules of ethics” to avoid potential conflicts of interest

Disclosure Requirements

- FRA is required to issue monthly financial reports, although some local politicians have criticized FRA for not publishing its operating expenses
- The disclosure requirements of AMC are not known
- Requirements for independent audits of financial statements for FRA and AMC are unknown

Independence

- FRA reportedly enjoys independence in day-to-day operations, although undoubtedly political and public criticisms that assets were being sold too cheaply to foreign investors influenced its decision to repackage some of the assets into smaller, less expensive tranches^e
- AMC operations are reportedly managed by the Ministry of Finance; the degree to which political considerations influence operational decisions is unknown
- Bidding price requires approval from AMC’s board of directors

FRA - Rapid disposition

- To dispose rapidly of the failed finance companies’ assets
- AMC - Maximize recoveries and enhance value
- To bid on FRA’s assets at fair prices and to maximize the value of the acquired assets by avoiding operational losses and increasing the assets’ net worth

AMC = asset management company, FRA = Financial Sector Restructuring Agency, IBRA/AMU = Indonesian Bank Restructuring Agency/Asset Management Unit, KAMCO = Korea Asset Management Corporation, NPA = nonperforming asset.

^a Ideally, an AMC should have operational independence, which refers to the freedom to make transactional decisions within policy guidelines, on the basis of economic merit and without undue political interference. The government’s role should be limited to establishing policies, approving strategies, and monitoring compliance. Independence almost certainly enables an AMC to operate more efficiently, but it does not necessarily prevent corruption. Nor, on the other hand, does a lack of political independence ensure corruption. If the government is corrupt, the AMC almost certainly will be corrupt. On the other hand, a completely independent AMC can also have corrupt management. Corruption is minimized through well-established rules of ethics and proper monitoring of compliance.

^b Legislative authority to make capital advances is under discussion.

^c In this study, day-to-day operations are defined generally as hiring personnel, managing assets, packaging portfolios, and approving sale transactions.

^d In an agency where there are numerous sales transactions of different values, it is generally inefficient for the board to approve all transactions. In Thailand, however, most FRA sales were of auctioned portfolios of similar size and worth and the transactions were few. In this instance, it would appear that FRA board approval for all asset transactions was appropriate.

^e Smaller asset tranches generally enable more domestic bidders to participate in the auction process.

Source: Barents Group interviews with government officials, World Bank, IMF, and financial press.

Table A2.3: Asset Management and Disposition

Country	Debt Restructuring, Asset Management, and Disposition	Number, Type, and Amount of Loans Forced into Bankruptcy, Restructured	Assets Sold and Assets that Remain on Books
Indonesia (1997 to present)	<p>Debt Restructuring</p> <ul style="list-style-type: none"> Restructuring program does not include a principal reduction option, but IBRA/AMU may extend the maturity and grace period and reschedule debt installments according to cash-flow conditions Only four companies have reportedly signed up for the government's foreign-exchange debt-workout agency^a Under the government's other debt-workout agency,^b as of 24 September 1999, companies have reportedly reached debt restructuring agreements with their creditors, addressing about US\$3 billion in foreign-currency debt and Rp2.2 trillion in domestic-currency debt. In all, 251 companies are reported to have sought help, addressing US\$21.4 billion and Rp13.6 trillion in foreign- and domestic-currency debts. <p>Asset Management</p> <ul style="list-style-type: none"> Plans to contract out 80% of the loan accounts which constitute 20% of the total loan value; large corporate loans to be managed in-house Working capital will be made available to selected businesses; companies will be restructured and consolidated to "create value"; a division will be formed for property companies All distressed companies are required to submit business plans <p>Asset Disposition</p> <ul style="list-style-type: none"> Potential recovery strategies: debt-to-asset swaps, debt-to-equity swaps, strategic sales, initial public offerings, auctions, and profit-sharing schemes Plans to sell Rp17 trillion worth of assets by April 2000 	<ul style="list-style-type: none"> At least 45 out of the 200 largest debtors have signed letters of agreement for a restructuring program, although no workouts have been finalized 60% of its approximately 1,700 debtors could be restructured; 40% will be liquidated Expected to complete debt restructuring process for 400 debtors by end-1999 	<ul style="list-style-type: none"> Has sold Rp1.6 trillion worth of assets, through 26 auctions of bank-owned art and vehicles, raising some Rp200 billion Other assets to be sold in 1999: office equipment and furniture, real estate, and securities and investments Plans to recover 27% of assets by end-1999
Korea (1997 to present)	<p>Debt Restructuring</p> <ul style="list-style-type: none"> May restructure debt, allow partial forgiveness, or amend loan terms The government-sponsored debt-workout agency^c reportedly has 102 applicants; 80 companies have reached restructuring agreements totaling W33.6 trillion <p>Asset Management</p> <ul style="list-style-type: none"> KAMCO will determine the value of each distressed business and then use its own resources to manage and upgrade the marketability of the asset Legislative authority to make capital advances under discussion KAMCO plans to establish joint ventures with seven foreign investors to dispose of distressed assets; each joint venture would have about W300 billion in assets and would be 65%-owned by the foreign partner <p>Asset Disposition</p> <ul style="list-style-type: none"> Will quickly sell assets with low value, will hold assets with potential for higher returns Potential recovery strategies: debt restructuring, sales, asset-backed securities, profit-sharing agreements, auctions, and asset restructuring KAMCO sold its assets through a series of public auctions and securitizations; US investment banks purchased most of the assets Legislation under review would permit KAMCO to swap debt for equity Plans to hold one auction and issue one asset-backed security every month 	<ul style="list-style-type: none"> KAMCO is assessing the viability of business assets It is not known what level of NPAs has been restructured or liquidated 	<ul style="list-style-type: none"> As of July 1999, sold about W6 trillion in assets through asset-backed securities, public auctions, and voluntary debt repayments Received about 40% of book value (assets representing higher-quality assets) Plans to dispose of W67 trillion of NPAs by end-2003: W16 trillion in 1999; W17 trillion in 2000; W14 trillion in 2001; W11 trillion in 2002; and W9 trillion in 2003
Malaysia (1998 to present)	<p>Debt Restructuring</p> <ul style="list-style-type: none"> As of July 1999, Danaharta had met with borrowers representing RM23 billion (61%) of loan portfolio Evaluating restructuring proposals totaling RM11 billion Under the central bank's debt-workout agency,^d 62 applications involving RM35 billion have been filed; 13 restructuring schemes involving RM11.3 billion have been completed and are in the process of being implemented; 3 cases involving debts of RM1.1 billion have been sold to Danaharta <p>Asset Management</p> <ul style="list-style-type: none"> Business assets will be restructured, consolidated, and managed under Danaharta subsidiaries (e.g. hotel and property) 	<ul style="list-style-type: none"> Borrowers with loans of 29% of Danaharta's portfolio (RM11 billion) have presented restructuring proposals to Danaharta 8% of Danaharta's loan portfolio (RM3 billion) has been restructured and is pending implementation 	<ul style="list-style-type: none"> In its first restricted tender of foreign loans in August 1999, sold about RM205 million in assets (including RM142 million in cash and RM63 million in non-ringgit Malaysian loan assets) Received about 55% of book value

Country	Debt Restructuring, Asset Management, and Disposition	Number, Type, and Amount of Loans Forced into Bankruptcy, Restructured	Assets Sold and Assets that Remain on Books
	<ul style="list-style-type: none"> Danaharta reports that it can maximize value of loans using superpowers <p>Asset Disposition</p> <ul style="list-style-type: none"> Recovery strategies: immediately sell the asset to a third party, provide borrower time to refinance, reschedule the loan, provide funding to enhance a business's viability, swap debt for equity, and liquidate the asset Held its first restricted tender of foreign loan assets in August 1999; US investment banks were the successful bidders Has plans to hold real estate auctions every three months, with the first auction, consisting of 30–50 industrial, commercial, and residential properties, scheduled for November 1999 Has the right not to sell any of the portfolios at a price below its estimated fair value 	<ul style="list-style-type: none"> RM600 million worth of debt has been regularized by borrowers 	
Thailand (1997 to present)	<p>Debt Restructuring</p> <ul style="list-style-type: none"> AMC can restructure debt with borrowers; FRA could not Under the central bank's debt-workout agency,¹ 52 cases reportedly have been restructured (out of 689 targeted debtors), representing approximately B120 billion; 340 companies have signed agreements, totaling B787 billion worth of debt (accounting for 30% of system NPLs) <p>Asset Management</p> <ul style="list-style-type: none"> FRA's mandate was to dispose of the assets and not to manage them for value Interim servicing of assets by FRA does not appear to have been a priority consideration AMC may support viable debtors with additional loans provided by commercial banks; currently seeking B8 billion <p>Asset Disposition</p> <ul style="list-style-type: none"> FRA sold its assets through a series of public auctions; US investment banks and AMC purchased most of the assets Before March 1999, when AMC was permitted to bid, FRA had the right not to sell any of the portfolios at a price below its established benchmark price For some portfolio sales, FRA used profit-sharing agreements, where a percentage of the bid price was paid in cash and the rest was paid from cash flows the purchaser received, after deducting operating expenses from servicing the asset Potential recovery strategies for AMC include: debt-equity swaps; private placements; bidding; securitization; and sales agent distribution 	<ul style="list-style-type: none"> New bankruptcy laws have facilitated the debt restructuring process AMC has succeeded in restructuring the debts of the 75 largest debtors (out of 2,980) 	<p>FRA</p> <ul style="list-style-type: none"> Sold about B730 billion in assets at a 75% discount^e <ul style="list-style-type: none"> Auto hire-purchase: B25 billion (52% discount) Residential mortgages: B12 billion (53% discount) Noncore assets: B34 billion (77% discount) Business loans: B79 billion (79% discount) Construction: B0.2 billion (85% discount) Commercial and other loans: B31 billion (76% discount) Last auction of B30 billion planned for November 1999 FRA plans to file bankruptcy lawsuits against the debtors of the approximately B100 billion remaining <p>AMC</p> <ul style="list-style-type: none"> Has not yet sold any assets

^a In June 1998, the government created the Indonesian Debt Restructuring Agency (INDRA) to provide foreign-exchange cover for Indonesian corporations with foreign-denominated debt, once they have reached debt rescheduling agreements. Analysts claim that the agency cannot offer much help in handling the complexities of the companies' problems.

^b In September 1998, the government formed the Jakarta Initiative Task Force (JITF) to serve as a mediator between debtors and creditors.

^c The Corporate Restructuring Committee was established by the Financial Supervisory Commission to facilitate the rehabilitation of viable companies. According to the program, when a company is included in the list of loan workout applicants, the company and its creditors will sign a contract, under which creditors will exercise management rights. Creditor banks of the troubled company will set up a committee that will decide its viability. If regarded viable, the company will be given an opportunity for rehabilitation through a loan workout. If not, it will be liquidated.

^d The Corporate Debt Restructuring Committee (CDRC) was established in August 1998 to assist companies with total debts of more than RM50 million in restructuring their debts. The CDRC framework calls for the financial institutions to voluntarily give the debtor a reasonable period of time for creditors or appointed consultants to determine the debtor company's financial health and needs before further decisions are made. To meet its 10 percent limit for NPLs, a financial institution may initiate workout proceedings with CDRC. As part of the process, an initial meeting is held with the debtors and creditors to consider the debt restructuring exercise and to obtain a temporary standstill agreement. A creditors' committee is formed and the lead creditor and consultants are appointed. The consultant conducts an initial review and reports the findings on the viability of the business. If the restructuring exercise proceeds, a formal standstill is executed among the creditors and the consultants formulate a workout strategy. Finally, the strategy is implemented. A borrower needs approval from 75 percent of the creditors. Once the loan is restructured, it is considered current and performing.

^e The less-than-expected results of the auctions have been blamed on a number of factors: the failure of Parliament to pass legal reforms, the high number of loans in litigation; the poor quality of the assets, the large size of lots, prior commitments to the IMF, time limitations for due diligence reviews (six weeks), the prohibition against direct foreign ownership of land, and inaccurate valuation methods.

^f The Corporate Debt Restructuring Advisory Committee (CDRAC) was established by the government in August 1998 to promote market-based corporate debt restructuring. CDRAC encourages creditors to choose between a voluntary restructuring process, court-supervised reorganization, or bankruptcy within 90 days of the initial meeting between the lead creditor and the debtor. It also encourages creditors to develop a method for arbitrating disagreements among themselves through a draft arbitration contract. If creditors are unable to devise a method for facilitating an agreement on a restructuring plan, the central bank uses its own authority to resolve disputes among financial institution creditors that arise during voluntary corporate workouts.

Source: Barents Group interviews with government officials, World Bank, IMF, and financial press.

Table A2.4: Asset Transfer Process

Country	Criteria for Asset Transfer and Transfer Price	Process of Asset Transfer	Amount and Breakdown of Assets Transferred
Indonesia (1997 to present)	<ul style="list-style-type: none"> • IBRA/AMU paid Rp1 for category 5 loans^a • IBRA/AMU reportedly uses discounted cash flow method to estimate fair value of category 3 and 4 loans • The extent to which estimated fair value exceeds current market value is unknown • NPAs from banks closed in March 1999 are reportedly to be sold to IBRA/AMU at net book value • It is unclear what average discount of book value IBRA paid for the assets 	<ul style="list-style-type: none"> • Banks under IBRA control/ supervision were required to sell their category 5 loans to AMU • Banks have the option to sell their other nonperforming loans to IBRA if they can agree to a price^c • Assets transferred on an ongoing basis as banks came under control of the government; more assets may be transferred if banking system continues to deteriorate • IBRA/AMU pays for NPAs with government-guaranteed bonds • IBRA does not appear to have a strategy for acquiring assets 	<p>Amount of total assets transferred to IBRA/AMU:</p> <ul style="list-style-type: none"> • Gross value of about Rp430 trillion^b representing: <ul style="list-style-type: none"> – 55% of total commercial bank assets (1997) – 66% of total nonperforming loans (at peak) – 68% of GDP (1997) <p>Breakdown of assets transferred to IBRA/AMU:</p> <ul style="list-style-type: none"> • About Rp100 trillion in industrial assets, consisting of equity stakes in over 200 companies;^d majority of assets to property-related businesses • About 75% of loans are to large corporate accounts <p>Nonperforming loans left in banks:</p> <ul style="list-style-type: none"> • Only category 5 loans were required to be sold • IBRA/AMU is expected to control most of the system's NPLs
Korea (1997 to present)	<ul style="list-style-type: none"> • In the past, KAMCO purchased NPAs in batches from banks at a fixed purchase rate based on the expected recovery value of a portfolio • Since September 1998, KAMCO has used a fixed purchase rate for ordinary loans in default, but making no payment. The rate is <i>secured</i> – appraised value of collateral minus the senior lien amount times 45%; <i>unsecured</i> – principal loan amount times 3% • For special loans that have obtained court approval for restructuring, the fixed purchase rate is: <i>secured</i> – loan amount times 45%; <i>unsecured</i> – principal loan amount times 3% • Purchases assets at an average discount of 44% of book value • The extent to which estimated fair value exceeds current market value is unknown, although the revised pricing methodology appears to reduce value differences 	<ul style="list-style-type: none"> • Government requires banks with capital adequacy ratios below 8% to sell their NPLs to KAMCO • Assets continued to be transferred • Beginning in February 1998, KAMCO paid for all NPLs with government-guaranteed bonds • KAMCO's asset acquisition strategy was price- rather than type-driven as it placed bids on all asset portfolios except for certain types of assets such as those in bankruptcy proceedings 	<p>Amount of total assets transferred to KAMCO:</p> <ul style="list-style-type: none"> • Gross value of about W46 trillion representing: <ul style="list-style-type: none"> – 9% of total commercial bank assets (1997) – 40% of total nonperforming loans (at peak) – 11% of GDP (1997) <p>Breakdown of assets transferred to KAMCO:</p> <ul style="list-style-type: none"> • A detailed breakdown of inventory assets is not available, although KAMCO is in the process of implementing a more effective inventory system • Approximately one third of KAMCO's loans are to <i>chaebol</i> and other large corporations • It is estimated that about 50% of all NPAs are factories or businesses • Portfolio includes approximately 170,000 loans that are being managed in-house, of which 32,000 are secured. Of these loans, the largest 1,500 largest borrowers represent about 90% of the portfolio's book value • About 233,000 other loans, representing less than 15% of the portfolio's book value, are being serviced by third parties <p>Nonperforming loans left in banks:</p> <ul style="list-style-type: none"> • KAMCO expected to purchase another W20 trillion in bad loans by end-1999 • KAMCO has recently been authorized to purchase foreign-currency-denominated NPLs

Malaysia (1998 to present)	<ul style="list-style-type: none"> Financial institutions submitted details of all NPLs worth at least RM5 million to Danaharta Using a discounted cash flow model, Danaharta estimates fair value for selected assets above RM5 million The extent to which estimated fair value exceeds current market value is unknown Danaharta indicated that it would only purchase loans that are, or have the potential to be, of value Purchases assets at an average discount of 40% of book value 	<ul style="list-style-type: none"> Government requires all banks to reduce NPL levels to 10% or below^e Assets transferred on an ongoing basis; asset transfer complete for bulk of NPLs Government requires banks that received capital from Danamodal^g to sell their NPLs above RM5 million to Danaharta Profit-sharing arrangement exists between banks and Danaharta on asset recoveries, with the banks to receive 80% of any profits earned from asset recoveries^h Danaharta paid for NPLs with government-guaranteed bonds 	<p>Amount of total assets transferred to Danaharta:</p> <ul style="list-style-type: none"> Gross value of about RM40 billion^f representing: <ul style="list-style-type: none"> – 6% of total commercial bank/finance company assets (1997) – 34% of total nonperforming loans (at peak) – 15% of GDP (1997) <p>Breakdown of property assets transferred to/ managed by Danaharta:</p> <ul style="list-style-type: none"> Development projects 58%, industrial 12%, office space 9%, retail space 8%, hotels 7%, agricultural land 4%, and residential 2% About 2,000 loan accounts <p>Nonperforming loans left in banks:</p> <ul style="list-style-type: none"> Finance companies' NPLs under RM5 million to be sold to a special-purpose vehicle
Thailand (1997 to present)	<ul style="list-style-type: none"> FRA managed the liquidation of all failed finance company assets; transfer price not applicable Beginning in March 1999, if FRA determined that a private-sector bid on primarily commercial loans did not meet internal benchmarks, AMC was permitted to bid on the assets It is unknown how FRA calculated its internal benchmarks AMC reportedly uses a discounted cash flow method to estimate fair value of FRA assets The extent to which estimated fair value exceeds current market value is unknown AMC paid 25% of book value for FRA's assets on the average 	<ul style="list-style-type: none"> FRA assigned responsibility for closed finance companies' assets; assets transferred from FRA to AMC on an ongoing basis Beginning March 1999, AMC was allowed to act as the bidder of last resort on FRA's assets at public auctions; transfer of assets from FRA to AMC completed AMC paid for FRA assets with partially guaranteed government bonds AMC asset acquisition strategy was price-rather than type-driven Commercial banks are permitted to sell their assets to separate bank-based AMCs 	<p>Amount of total assets transferred to FRA:</p> <ul style="list-style-type: none"> Gross value of about B860 billion representing: <ul style="list-style-type: none"> – 12% of total commercial bank/finance company assets (1997) – 26% of total nonperforming loans (at peak) – 18% of GDP (1997) <p>Breakdown of assets transferred to FRA:</p> <ul style="list-style-type: none"> About 10% hire-purchase; 5% residential mortgages; 40% noncore; 45% business loans About 60% of the assets were secured by real estate <p>Amount of total assets acquired by AMC (from FRA):</p> <ul style="list-style-type: none"> Gross value of about B185 billion represented: <ul style="list-style-type: none"> – 3% of total commercial bank/finance company assets (1997) – 6% of total nonperforming loans (at peak) – 4% of GDP (1997) <p>Breakdown of assets transferred to AMC (from FRA)</p> <ul style="list-style-type: none"> About 70% of assets are real estate projects <p>Nonperforming loans left in banks:</p> <ul style="list-style-type: none"> Only finance company assets were transferred to the FRA and AMC; government is considering permitting AMC to buy the banks' NPAs

AMC = asset management company, FRA = Financial Sector Restructuring Agency, GDP = gross domestic product, IBRA/AMU = Indonesian Bank Restructuring Agency/Asset Management Unit, KAMCO = Korea Asset Management Corporation, NPA = nonperforming asset, NPL = nonperforming loan.

^a A loan that is at least 270 days past due.

^b Includes category 5 loans (Rp230 trillion) and assets received from bank owners in settlement of their obligation to repay liquidity support from the central bank.

^c If the bank believes that IBRA's price is too low, it can keep the loan and try to restructure it itself.

^d Technically, the firms belong to the original owners until they are sold, at which point the state will keep the proceeds.

^e Banks that decide not to accept Danaharta's offer must write down their unsold NPLs to 80% of the offer made by Danaharta.

^f Includes RM18 billion worth of assets acquired by Danaharta and RM22 billion worth of assets under management on behalf of the central bank.

^g Danamodal was established as a special-purpose entity to recapitalize the banking sector. The agency injects capital for equity shares in the bank. The banks are permitted to buy back the shares if they can provide Danamodal a 12% return. If the banks do not begin to improve their conditions within 3–5 years, Danamodal may sell their shares in the market. Danamodal has reported that it will need RM16 billion, although market analysts have estimated this figure to be at least RM50 billion.

^h Banks are also permitted to amortize any losses on NPLs sold to Danaharta over a five-year period.

Source: Barents Group interviews with government officials, World Bank, IMF, and financial press.

Table A2.5: Legal Environment and Management

Country	Sunset Clause/ Time Frame	Broader Legal Environment	Organization/ Human Resources	Funding
Indonesia (1997 to present)	<ul style="list-style-type: none"> • No sunset clause • Plans to operate for 3–7 years 	<p>Adequacy of Bankruptcy and Foreclosure Law</p> <ul style="list-style-type: none"> • Court system has been criticized for being inefficient and corrupt. Recent revisions in the bankruptcy law, including creation of new bankruptcy court, are expected to improve the system • Process of enforcing secured claims is time-consuming, expensive, and unpredictable • Debtors, creditors, and public prosecutor can initiate bankruptcy proceedings. Court may appoint a receiver to carry out a reorganization • In bankruptcy, secured claims are subordinated to court expenses, auction costs, and taxes owed <p>Special Power</p> <ul style="list-style-type: none"> • AMU can foreclose on a loan without going through the court; can buy/sell loan without debtor approval 	<ul style="list-style-type: none"> • AMU is organized into two divisions: asset management credit and asset management investment • Most employees are from the private sector • Staffing requirements of IBRA/AMU are unknown 	<ul style="list-style-type: none"> • IBRA/AMU expenditures will be funded from asset recoveries, sale of equity of nationalized banks, and bond issuances • IBRA/AMU maintains that funding costs are constantly being evaluated and are a moving target • As of February 1999, IBRA estimated that it needed Rp140 trillion to resolve banking sector problems, but also indicated that additional funding would likely be required
Korea (1997 to present)	<ul style="list-style-type: none"> • No sunset clause • Plans to operate for 6 years 	<p>Adequacy of Bankruptcy and Foreclosure Law</p> <ul style="list-style-type: none"> • Relatively well established and reasonably efficient process. Debtors, creditors, or shareholders may initiate bankruptcy proceedings. Debtors may petition for payment relief. • Court decision process is often lengthy because of a heavy caseload. Creditor actions are frozen during the decision process. Court may appoint a receiver to carry out a reorganization, although it often leaves existing management in place. • Secured creditors generally can enforce claims efficiently through courts. In reorganizations, secured claims retain priority. <p>Special Power</p> <ul style="list-style-type: none"> • No special authority - pending legislation would permit KAMCO to appoint a Special Administrator to manage a borrower's business or assets or both 	<ul style="list-style-type: none"> • Organized into 13 departments • KAMCO was established as part of an organization that had experience in foreclosing assets • Most new employees have domestic banking experience • Staffing requirements of KAMCO are unknown • Private-sector wage scale • Some assets have been contracted out for private management 	<ul style="list-style-type: none"> • As of May 1999: <ul style="list-style-type: none"> - W32 trillion authorized - W28.6 trillion disbursed • About 90% of funding comes through government-guaranteed bonds, 5% from the central bank, and 5% from financial institutions including the Korea Development Bank
Malaysia (1998 to present)	<ul style="list-style-type: none"> • No sunset clause • Plans to operate for 7–10 years 	<p>Adequacy of Bankruptcy and Foreclosure Law</p> <ul style="list-style-type: none"> • Conducive to restructuring, but process can be cumbersome and costly. Debtors must obtain the majority consent of creditors before filing for bankruptcy protection. Creditors can petition for payment relief. 	<ul style="list-style-type: none"> • Organized into six departments • Employees have private-sector experience in banking, real estate, and business • Staffing requirements of Danaharta are unknown 	<ul style="list-style-type: none"> • Initial estimates of RM25 billion reduced to RM15 billion apparently because of perceived improvements in economic conditions • RM10 billion funded through bonds, RM3.5 billion through state-owned

- Secured creditors retain priority in bankruptcy; can appoint receiver in liquidation and sell assets to satisfy claims.
- Danaharta's Special Powers**
- Can override Section 176 of Companies Act, which provides debtors temporary protection from creditors
 - Statutory vesting permits Danaharta to step into the shoes of the selling institution, with the same rights and priority as a creditor
 - Can appoint a Special Administrator to take over a distressed company
- Private-sector wage scale
 - Local and international advisers include consultants, accountants, and industry experts
 - It is not known whether Danaharta plans to contract out a portion of the assets to private management
- enterprise (SOE) loans, and RM1.5 billion provided by the government as seed capital

Thailand
(1997 to
present)

FRA

- No sunset clause, although the board of directors has reportedly been authorized to exist until 2003

AMC

- No sunset clause
- Plans to operate for 5–7 years

Adequacy of Bankruptcy and Foreclosure Law

- Enforcement of secured claims has not been efficient, but recent legal reforms reportedly will allow for swift asset foreclosure for debtors not in court-approved reorganization
- A special bankruptcy court has been created to promote loan workouts. Its authority to declare firms bankrupt is limited, but it may appoint financial planners to work out five-year debt restructuring plans and a receiver to manage a troubled company. Insolvent debtors may not initiate liquidation process. Secured creditor claims have priority to assets secured before receivership.
- Law also revised to permit foreign land and business ownership, promote asset securitization, and establish procedures for privatizing state assets

Special Power

- AMC is exempt from notifying debtors of transfers of claim as required by law. It is also exempt from certain fees and taxes. No superpowers for FRA

- FRA is organized into 8 divisions and the AMC into 13 divisions
- FRA employs about 270 people, mostly from the private sector
- Funded under a World Bank technical assistance loan, FRA hired external advisers in banking, asset management, law, accounting, and public relations
- AMC is employing private-sector professionals; does not plan to hire FRA employees
- AMC plans to contract out a portion of its assets for private management, although the volume is unknown
- Staffing requirements of FRA and AMC are unknown

- The acquisition of FRA's assets was funded through the Financial Institutions Development Fund.^a The World Bank provided seed capital
- The government provided AMC B15 billion in seed capital; can raise this up to B180 billion through partially guaranteed government bonds
- Several banks have indicated their willingness to provide financing for AMC's distressed assets, although it is unclear if the government would guarantee these loans

AMC = asset management company, FRA = Financial Sector Restructuring Agency, IBRA/AMU = Indonesian Bank Restructuring Agency/Asset Management Unit, KAMCO = Korea Asset Management Corporation.

^a The role of the Financial Institutions Development Fund (FIDF), initially set up to provide liquidity support, was expanded in 1997 to protect domestic and foreign depositors and creditors of all operating financial institutions. In 1997, the FIDF began to recapitalize troubled finance companies, which facilitated the transfer of assets to FRA. Through 1998, the FIDF extended about B400 billion, or about 8% of GDP, to the 58 troubled finance companies, becoming their largest debtor with over 80% of total liabilities.

Source: Barents Group interviews with government officials, World Bank, IMF, and financial press.

Table A2.6: Potential Impediments to Success

General observations on surveyed countries:

Transparency – Additional publications of policies, procedures, and audited reports would help to increase public acceptance and decrease potential for corruption

Corruption – Safeguards against corruption would benefit from establishing, publishing, and independently enforcing a uniform code of ethics to govern employees and operational transactions

Conflicts of Interest – In addition to a code of ethics for employees, guidelines should be established to govern potential conflicts of interest relating to the activities of advisers

Independence – Explicit restrictions against political interference in transactions would enhance operational independence

Trained Professionals – Attracting well-qualified people is a major challenge given the lack of trained and experienced asset management and disposition professionals

Information Systems – Improvements in management information systems would help to value and service inventoried assets more effectively

Business Plans – Operations would be enhanced by more detailed business plans regarding the management and disposition of assets

Valuation – Asset valuations need to reconcile differences between estimated fair value and current market value with disposition objectives

Value Enhancement – In general, any attempt to create value by restructuring businesses and consolidating industries should be discouraged because of the potential for market disruption, loss, increases, and corrupt influences. Any decisions to engage in such practices should be made independently and after thorough and rigorous analysis and documentation to quantify the potential risks and benefits

Notes

¹East Asia is taken to refer to the crisis-affected countries of Indonesia, Korea, Malaysia, Thailand, and, to a lesser extent, the Philippines.

²The severity of nonperforming assets is typically measured by nonperforming loan (NPL) and NPA ratios. The NPL ratio refers to the ratio of loans classified as “nonperforming” to total loans (usually including financial leases). The ratio indicates the overall quality of the loan portfolio. The NPA ratio is the ratio of nonperforming loans plus foreclosed real estate (and other assets) owned to total loans plus foreclosed assets, or to total assets. The NPA ratio is more encompassing than the NPL ratio and is a useful indicator of the liquidity and earnings health of a financial institution. Unfortunately, differences in accounting and regulatory requirements make it difficult to compare NPL and NPA ratios across countries. There is no uniform definition for either the NPL or the NPA ratio because different countries have different ways of classifying nonperforming loans and valuing foreclosed assets. Although their problem assets initially consist primarily of nonperforming loans, banks and asset management companies must resolve as well the collateral assets they acquire. Therefore, this chapter primarily uses NPA, instead of NPL, levels and ratios.

³The study is based primarily on available data as of April 1999. In view of the rapidly changing environment, information on asset disposition and corporate restructuring was updated, where possible, as of September 1999.

⁴See footnote 2 for a discussion of nonperforming loans and assets.

⁵It is worthy of note that the fiscal-cost-to-GDP ratios estimated by the IMF for East Asia in Table 4 average only slightly more than half the peak NPL-to-GDP ratios shown in Table 3. By comparison, in the US, resolution costs were closer to two thirds of NPL-to-GDP ratios.

⁶Loss provisions typically depend on how long a loan has been delinquent, and range from 20 to 100 percent against the unsecured portion of the loan. As is the case with classification standards based on delinquency status, values assigned to collateral also tend to be more liberal in East Asia than in the US.

⁷“Net interest margin” refers to the difference between interest earned on loans and other interest-bearing assets and the interest paid to depositors and other creditors. It is usually expressed as a percentage of average earning assets.

⁸Information on the Philippines was not made available by the central bank.

⁹Sheng (1996).

¹⁰Legislation creating the Resolution Trust Corporation (RTC) restricted the sale of assets for less than 95 percent of fair value in certain markets. Originally, RTC relied heavily on appraised values in setting prices but quickly moved to placing greater reliance on an open and competitive bidding process to determine values.

¹¹Caprio, et al. (1998).

¹²Kawai (1999).

¹³Alexander, et al. (1997).

¹⁴In the US, most, if not all, banks with the NPA levels typically seen in East Asia were taken over by the government. The good parts were sold to healthy banks while the bad assets were managed either by the Federal Deposit Insurance corporation or RTC. Other banks typically handled their nonperforming assets in separate workout departments or within the normal loan department. Some banks established separate asset management entities to manage assets for the government or themselves but most such entities have since been dissolved or sold.

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